85-599

No.

In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

AMERICAN BAR ENDOWMENT

UNITED STATES OF AMERICA, PETITIONER

v.

FREDERIC D. TURNER, ET UX., ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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QUESTIONS PRESENTED

1. Whether income derived by a tax-exempt professional organization from the sale of group insurance to its members is "unrelated business income" subject to tax under Sections 511 through 513 of the Internal Revenue Code.

2. Whether an insured member's assignment of his policy dividends to the organization, when the assignment is a requirement of purchasing the insurance, is deductible as a "charitable contribution" under Section 170 of the Code.

PARTIES TO THE PROCEEDING

In addition to the parties named in the caption, Arthur M. Sherwood (and his wife), Herbert C. Broadfoot II (and his wife), and Frederick G. Boynton are respondents.

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The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in these cases.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-23a) is reported at 761 F.2d 1573. The opinion of the Claims Court (App., *infra*, 25a-58a) is reported at 4 Cl. Ct. 404.

JURISDICTION

The judgment of the court of appeals (App., *infra*, 24a) was entered on May 10, 1985. On July 31, 1985, the Chief Justice extended the time within which to petition for a writ of certiorari to and including October 7, 1985. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 501, 511, 512, and 513 of the Internal Revenue Code of 1954 (26 U.S.C.), and of Sections 1.501(c)(6)-1 and 1.513-1 of the Treasury Regulations on Income Tax (26 C.F.R.), are set out in a statutory appendix (App., *infra*, 59a-76a).

STATEMENT

These cases were consolidated for trial and decision in the Claims Court and for briefing, argument and decision in the court of appeals. Although the cases are closely linked, they raise different legal issues and are most conveniently discussed separately.

A. American Bar Endowment

1. The American Bar Endowment is a corporation exempt from tax under Section 501(c)(3) of the Internal Revenue Code.[1] Its main purposes are to advance legal research and to promote the administration of justice. It accomplishes these purposes by making grants to other charitable and educational organizations (App., *infra*, 26a). All members of the American Bar Association (ABA) are members of the Endowment without paying additional dues (C.A. App. 116). The ABA is exempt from tax under Section 501(c)(6) as a "business league."

[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax periods in issue (the Code or I.R.C.).

The Endowment has conducted a group insurance program for ABA members since 1955 (App., *infra*, 27a). The program offers life, health, accident, and disability insurance underwritten by major insurance companies. Coverage for members' dependents is also available under some plans (*ibid.*). The life insurance plan, the most heavily subscribed, had $2.75 billion of insurance outstanding in 1980. More than 57,000 (or about one-fifth) of the Endowment's members were then enrolled in one or more of the plans (C.A. App. 143).

The Endowment administers its insurance plans with a staff of 40 (App., *infra*, 27a). It actively supports and officially endorses coverage under the plans, and solicits its members' enrollment through aggressive advertising prepared and distributed by its staff (C.A. App. 141, 811, 1248-1268). The staff also performs many tasks essential to the program's day-to-day operation, such as screening members' applications, collecting members' premiums, and forwarding premiums to the underwriters (*id.* at 141-142). Nearly all of the Endowment's operating budget is consumed by these activities (*id.* at 139).

The Endowment's contracts with its underwriters require the latter to calculate and refund to the Endowment annually any policy dividends or retrospective rate credits that accrue to the group policies (C.A. App. 120-122, 128). These sums, which we shall refer to collectively as "dividends," reflect the excess of the premiums paid by ABA members over the underwriters' cost of paying claims and servicing the plans (App., *infra*, 27a-30a). In order to enroll in the program, every insured must waive his claim to receive these dividends and must consent to their retention by the Endowment. This condition is stated on the insurance application forms, and the Endowment insists on its strict enforcement (*id.* at 3a-4a, 32a; C.A. App. 440-442). The Endowment applies the dividends, net of its plan administration expenses, to fund its educational projects. Every

year, it calculates the percentage of the overall premiums that have been thus applied, and advises its insured members that they may, in the opinion of the Endowment's counsel, deduct corresponding portions of their own premiums as tax-deductible charitable contributions (App., *infra*, 4a, 32a-33a; C.A. App. 867-871).

The Endowment's strategy is to maximize the policy dividends and thus maximize its profits. It uses its considerable leverage with the underwriters to tailor the insurance program to that end (App., *infra*, 3a-4a, 27a-30a). Because the plans are experience-rated, and because ABA members enjoy very favorable mortality and morbidity experience, the Endowment could, if it chose, offer insurance at very low premiums, perhaps at premiums approaching the lowest available for group insurance in the country (App., *infra*, 30a-32a). In order to produce the largest dollar volume of policy dividends, however, the Endowment sets the price of its insurance at rates comparable to those charged for other insurance products in the market (App., *infra*, 3a-4a, 27a-30a). The Endowment regularly reviews the market comparability of its prices and benefits and adjusts its premiums from time to time to keep them competitive (*ibid.*). By the same token, the Endowment takes care not to raise its premiums above the market range, for fear of discouraging participation (*ibid.*).

The use of prevailing market rates, coupled with the favorable mortality and morbidity experience of ABA members, has made the Endowment's insurance operations highly profitable. The amounts refunded to it as dividends often exceed 40% of the premiums its members pay (C.A. App. 560-561; App., *infra*, 4a). Income from its insurance operations is by far the major source of its revenue (C.A. App. 1319). The Endowment thus serves successfully as a middleman between its members and commercial vendors of insurance.

2. Sections 511 through 513 of the Internal Revenue Code impose a tax, at regular corporate rates, on the

"unrelated business taxable income" of otherwise tax-exempt organizations like the Endowment. An "unrelated trade or business" is one "the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other [tax-exempt] purpose" (I.R.C. § 513(a)). Section 513 (c) provides that "the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services."

The Endowment's gross policy dividends from its insurance operations during 1979-1981 aggregated almost $19 million (C.A. App. 129). On audit, the IRS determined that those revenues, less the Endowment's expenses of administering the insurance program, were subject to tax as "unrelated business income" (*id.* at 130, 139). The Commissioner accordingly determined tax deficiencies of approximately $6 million for the three years (*id.* at 130-132).

The Endowment paid the asserted deficiencies and, following denial of its administrative claims for refund, instituted this refund suit in the Claims Court. It conceded that its insurance operations were "regularly carried on" (I.R.C. § 512(a)). It likewise conceded that the conduct of those operations was "not substantially related" to the performance of its tax-exempt educational functions (I.R.C. § 513(a)). See C.A. App. 144. The Endowment's principal contention was that its insurance operations did not amount to a "trade or business," on the theory that they represented "contributions" that ABA members made "by foregoing the advantage of having premium refunds returned to them" (*id.* at 22-24).

Following a trial, the Claims Court entered judgment for the Endowment. It held that the profits derived by the Endowment from its insurance operations were im-

mune from unrelated business income tax because they did not arise from a "trade or business" within the meaning of Section 513(c). The court believed that its task in interpreting that Section was to "distinguish between those activities that constitute a trade or business and those that are merely fundraising" (App., *infra*, 33a-34a). The controlling test for this purpose, the court concluded, was whether the Endowment conducted its activities in "a competitive, commercial manner" (*id.* at 34a). The court then recited several factors that, "taken together, * * * ma[d]e it impossible * * * to conclude that the [Endowment's] insurance programs were operated" in a commercial or competitive way (*id.* at 40a). The Endowment's insurance program, the court said, was "label[led]" by it and "perceived" by its members as "a fundraising activity." The Endowment's profits, the court stated, were "astounding" and "[could] not be maintained in a competitive market." And "the insurance program," the court observed, "was operated with the approval and consent of the ABA membership." App., *infra*, 32a, 36a-38a. In the court's view, "an enterprise that depends on the consent of its customers for its profits is not operating in a commercial manner and is not a trade or business" (*id.* at 41a).

3. The Court of Appeals for the Federal Circuit affirmed. It concluded that the Claims Court had "properly found facts" and had "applied the correct standard" to determine whether the Endowment's insurance operations were a "trade or business" within the meaning of Section 513(c). See App., *infra*, 9a. Based on "the persistent and fundamental fund-raising motivation" of the Endowment's insurance program, "the knowledgeable approval of and consent to the program by the ABA's members," and the Endowment's "phenomenal success" in accumulating policy dividends, the court of appeals was persuaded that the Endowment's activities were not "competitive" or "commercial" and thus were immune from tax. *Id.* at 8a-9a.

The court of appeals described as "inapposite" (App., *infra*, 10a) decisions of the Fourth, Fifth, and Sixth Circuits holding that profits derived by tax-exempt professional or trade associations from the operation of group insurance plans are subject to unrelated business income tax. See *Professional Insurance Agents* v. *Commissioner*, 726 F.2d 1097 (6th Cir. 1984); *Carolinas Farm & Power Equipment Dealers* v. *United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League* v. *United States*, 693 F.2d 525 (5th Cir. 1982). In thus reasoning, the Federal Circuit relied principally on the fact that the organizations marketing the insurance in those cases were "[b]usiness leagues" exempt from tax under Section 501(c)(6), rather than charitable or educational associations exempt from tax (as is the Endowment) under Section 501(c)(3). The fact that the Endowment "set out to make as much profit as possible" did not in the court's view determine whether its insurance activities were a "trade or business" (App., *infra*, 11a). "Unlike what some other courts may do," the court of appeals observed, "this court does not find 'profits,' or the maximization of revenue, to be the controlling basis for a determination of whether the unrelated business tax provisions apply" (*ibid.*).

B. Frederic D. Turner, et ux., et al.

1. The individual respondents are ABA members who bought insurance from the Endowment (App., *infra*, 31a, 38a).[2] Each agreed, as a condition of enrollment, that the Endowment could keep any dividends apportioned to his policy (*ibid.*). Each knew, when he wrote his premium checks, that the Endowment would use the dividends to further its work in the legal field.

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[2] Respondents' wives are parties solely by virtue of having filed joint income tax returns with their husbands for the relevant tax years.

Respondents Turner and Sherwood signed up for life insurance in 1972. They enrolled after reading brochures explaining that the Endowment's insurance program raised money for educational purposes while offering attractive insurance benefits at a reasonable cost (C.A. App. 405-407, 414-415, 1027-1034, 1040-1047). The brochures principally described the "highlights" of the coverage that the Endowment offered for sale, including the option granted to members under 40 (as Turner and Sherwood then were) to be accepted without medical evidence of insurability (*ibid.*).

Respondent Broadfoot initially purchased life insurance in 1971 because, as he testified, "[m]y first child had recently been born and I was interested in obtaining some life insurance" (C.A. App. 388). He regarded the premiums charged as reasonable (*id.* at 402-403). At one time he carried a life policy through the Georgia State Bar but discontinued it after determining that it cost more than the Endowment's (*id.* at 396-399).

Respondent Boynton purchased disability insurance in 1978 (C.A. App. 74). He concluded after reading the Endowment's literature that its disability coverage was "reasonably or competitive[ly] priced" (*id.* at 430). Before applying for his policy, he examined a number of other disability plans. He found that two offered considerably greater benefits than the Endowment's but were more expensive (*id.* at 427, 429).

None of the individual respondents testified that, if given an option, he would have elected to assign his policy dividends to the Endowment. None testified that he chose the Endowment's coverage over a cheaper policy in order to further the Endowment's educational goals, or that he thought the premiums charged by the Endowment exceeded the economic value of the insurance he purchased. Two nonparty insureds, on the other hand, testified that they would have opted to keep their dividends had such an election been afforded (C.A. App. 592-593, 690-691). One testified that he had purchased

insurance from the Endowment because he found its premiums competitive and because he thought that the Endowment "would certainly have the clout to deal with the insurance company" (*id.* at 687-688). The other testified that his sole motive for signing up was to obtain insurance; he had previously held through his state bar association a group life policy that cost more than the Endowment's (C.A. App. 590-593, 596, 784-785).

2. Section 170(a) of the Code provides an income tax deduction for "charitable contribution[s]." Section 170(c)(2)(B) defines a "charitable contribution" as "a contribution or gift" to or for the use of an entity that is "organized and operated exclusively for religious, charitable * * * or educational purposes." None of the individual respondents deducted any part of the insurance premiums that he paid the Endowment as a "charitable contribution" on his tax return for the years at issue (C.A. App. 52-54, 64-66, 76-78, 86-89). Thereafter, respondents were invited, and agreed, to take part in this "test case" mounted by the ABA (*id.* at 409-410, 425). Each filed an administrative claim for refund, claiming a charitable contribution deduction ranging from 28% to 55% of the premiums he had paid. These percentages depended on the year and type of insurance involved, and were derived from notices issued to respondents by the Endowment (*id.* at 391-392, 407-408, 416-418, 423-424, 868-871). Each sought a refund of $40 or less (*id.* at 52-54, 64-66, 76-78, 86-89).

When the IRS demurred, respondents instituted these refund suits in the Claims Court. They contended that each premium they paid to the Endowment was a "dual payment," representing in part the purchase of insurance and in part a charitable donation (App., *infra*, 48a). The Claims Court, following a trial, entered judgment for the United States. It held that none of the respondents was entitled to a charitable contribution deduction for any portion of his premiums.

The court began by examining the relevant legal standards. In its view, an insured's "mere awareness" that the Endowment's insurance profits would be devoted to charitable purposes "is not sufficient to establish that he made a charitable contribution" (App., *infra*, 52a). Rather, "[t]o establish a dual payment, the taxpayer must demonstrate that he bought goods or services for more than their economic value, with the intention that the excess be used to benefit a charitable enterprise" (*id.* at 49a). Each respondent, in other words, had to show "that an equivalent insurance product was available to him for a lower price and that he bypassed that product because he wished to make a charitable contribution to the Endowment" (*id.* at 52a (footnote omitted)).

Turning to the facts of each case, the Claims Court concluded that none of the respondents had proved that his purchase of insurance from the Endowment reflected anything other than his own economic interest (App., *infra*, 52a-54a). Three of the respondents, the court found, had failed to establish that cheaper insurance was available to them elsewhere (*ibid.*). The fourth, while demonstrating that cheaper insurance existed, offered no proof that he knew about it during the tax years at issue and had elected to buy the Endowment's policy instead (*id.* at 55a). The court noted that the Endowment's advertising was "aggressive" and "in some ways suggested [that its insurance] may be the best deal in the market" (C.A. App. 811). Thus, if an ABA member "did not have the two plans side by side," he might well be unaware that he could have obtained a policy elsewhere for less (*id.* at 811-812).

3. The court of appeals reversed and remanded. It directed the Claims Court to conduct "such further proceedings as are appropriate to determine whether the relationship between the Endowment and the [individual respondents] was predominately of a business nature or whether the transaction did have a substantial charitable component" (App., *infra*, 22a-23a).

The Federal Circuit held that the inquiry conducted by the trial court—whether the respondents could have obtained comparable insurance coverage for less money—was "an incorrect definitization of the proper standard" (App., *infra*, 19a). The Claims Court's approach was wrong, the court of appeals said, because it required affirmative proof of "a charitable motivation of disinterested generosity" (*id.* at 19a-20a). The correct legal test, rather, in the court of appeals' view, was "whether the transaction between the Endowment and the taxpayers * * * was of a business nature and not charitable" based on "all the pertinent circumstances" (*id.* at 21a (original quotation marks omitted)). Such a test, the court opined, "should not be too difficult" for ABA members to pass (*id.* at 22a).

Finding the record "almost completely bare" as to the nature of the insureds' dealings with the Endowment, the court of appeals remanded their cases with instructions. Given "the Endowment's persistent and public efforts to enhance its charitable funds," the court suggested, members who bought insurance from it should be able "to present a *prima facie* case" for a charitable deduction "simply [by] mak[ing] a sworn assertion that they wanted to aid that charitable endeavor and entered the Endowment's plan because it enabled them to do so" (*ibid.*). Under the Federal Circuit's instructions, the government on remand would then have the burden to "controvert that position and [to] suggest factors showing that the transaction was basically business-oriented" (*ibid.*). On July 17, 1985, the court of appeals stayed proceedings on remand pending disposition of this petition.

REASONS FOR GRANTING THE PETITION

The court of appeals has decided two important questions of federal tax law in a way that conflicts directly with the decisions of other courts of appeals and with well-established tax principles. The first question pre-

sented is related to that on which this Court recently granted review in *United States* v. *American College of Physicians*, No. 84-1737 (July 1, 1985), also on certiorari to the Federal Circuit. The second question presented is inextricably bound with the first, involving the effect of the insurance purchase from the buyer's rather than the seller's viewpoint. The questions have considerable administrative importance and potentially involve hundreds of millions of dollars in revenue. Review by this Court is therefore appropriate.

A. American Bar Endowment

1. a. The court of appeals' holding concerning the taxability of the Endowment's insurance operations squarely conflicts with recent decisions of the Fourth, Fifth and Sixth Circuits. See *Carolinas Farm & Power Equipment Dealers* v. *United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League* v. *United States*, 693 F.2d 525 (5th Cir. 1982); *Professional Insurance Agents* v. *Commissioner*, 726 F.2d 1097 (6th Cir. 1984). The organization involved in each of those cases was a tax-exempt association which, like the Endowment, drew its members exclusively from a single trade or profession. Each operated a group insurance program for its members. Like the Endowment, each selected an insurer to underwrite its program, actively promoted and marketed its group coverage to its members, performed day-to-day tasks of administering the program, and received rebates of the members' premiums from the underwriters. Like the Endowment, each association made sizable profits on its insurance operations, yet contended that they did not constitute a "trade or business" within the meaning of Section 513(c).

In *Louisiana Credit Union League* v. *United States*, *supra*, the Fifth Circuit squarely rejected that argument (693 F.2d at 531-534). It noted that Section 513(c) defines a "trade or business" to include "any activity which is carried on for the production of income from the sale of goods or the performance of services." Since the association both sold insurance and performed services in administering its plans, and since it "had a profit motive for its activities," the Fifth Circuit held that it was engaged in a "trade or business" and that its insurance profits were thus subject to unrelated business income tax (693 F.2d at 532-534). As the court put it (*id.* at 532):

> We believe that the "profit motive" standard is the proper one to be applied in this case, for it is consistent with the plain language of section 513 as well as the accompanying regulations. The statute, which clearly encompasses within its parameters any activity "carried on for the production of income," first raises the issue of motive. The regulations, which invoke section 162 and its "profit motive" gloss, confirm that motive is the key inquiry. Thus, to determine whether a tax-exempt organization is carrying on a trade or business, the court must look to see whether that institution is engaged in extensive activity over a substantial period of time with the intent to earn a profit.

The Fourth and Sixth Circuits, on virtually identical facts, have reached the same conclusion for the same reasons. See *Carolinas Farm & Power Equipment Dealers* v. *United States*, 699 F.2d at 170 (adopting "profit motive" test); *Professional Insurance Agents* v. *Commissioner*, 726 F.2d at 1102 (same).

The decision below squarely rejects both the legal standard applied by these courts and the tax result they reached. Whereas the Fourth, Fifth and Sixth Circuits employed a "profit motive" test for determining the existence of a "trade or business" under Section 513(c), the Federal Circuit below declared: "Unlike what some other courts may do, this court does not find 'profits,' or the maximization of revenue, to be the controlling basis for [that] determination" (App., *infra*, 11a). And whereas the Fourth, Fifth and Sixth Circuits have held that insurance profits of exempt organizations are subject to unrelated business income tax, the court below, on substantially identical facts, has ruled such profits tax-free.

b. In finding these conflicting decisions "inapposite," the Federal Circuit (App., *infra*, 10a), like the Claims Court (*id.* at 25a-26a), relied principally on the fact that the associations marketing the insurance there were organized as "[b]usiness leagues" exempt from tax under Section 501(c)(6), rather than as charitable or educational associations exempt from tax (as is the Endowment) under Section 501(c)(3). This is precisely the same meaningless distinction that the respondent in *United States* v. *American College of Physicians*, *supra*, urged upon this Court in unsuccessfully opposing certiorari in that case (84-1737 Br. in Opp. 12). The respondent there, like the Endowment, is a professional association tax-exempt under Section 501(c)(3). In an effort to avoid tax on its profits from the publication of commercial advertising, it urged that Treasury Regulations holding such activities to be an "unrelated trade or business" should be construed to apply only to the advertising operations of Section 501(c)(6) groups, and not to identical advertising operations of Section 501(c)(3) groups (84-1737 Br. in Opp. 11-13, 15).

As we have pointed out in greater detail in our briefs in *United States* v. *American College of Physicians* (84-1737 Reply Br. at 4-8; U.S. Br. at 33-40),[3] the subsection of Section 501(c) under which a professional association happens to be organized makes absolutely no difference in determining the taxability of its profit-motivated activities. The question here is whether the Endowment's insurance operations are a "trade or business." Those words are defined in Section 513(c), and that definition applies to *all* tax-exempt organizations, regardless of the particular subsection of Section 501(c)—there are more than twenty—on which they base their tax-exempt status. Under that definition, it is the nature of the activities conducted, not the origin of the exemption, that determines the taxability of the profits realized. There is, accordingly, no statutory basis for contending that insurance operations conducted by Section 501(c)(6) groups are a "trade or business," but that the Endowment's substantially identical insurance operations are not a "trade or business," simply because the Endowment chose to be organized under Section 501(c)(3). Indeed, such a contention would be particularly strained here, since the Endowment is a Section 501(c)(3) affiliate of the ABA, which is *itself* a Section 501(c)(6) business league. On the court of appeals' theory, any business league could escape tax on its insurance operations—operations that would be subject to tax under the decisions of the Fourth, Fifth, and Sixth Circuits—simply by spinning off those operations into a Section 501(c)(3) sister corporation. This in effect would make payment of the unrelated business income tax *elective*, a result that Congress would surely find rather surprising.

[3] We are providing copies of these briefs to counsel for respondents in this case.

2. a. In declining to follow the holdings of the Fourth, Fifth and Sixth Circuits, and in rejecting the legal standard those courts adopted, the Federal Circuit has ignored both the express language of Section 513(c) and Congress's intention in enacting the unrelated business income tax. Before that law was enacted (Revenue Act of 1950, ch. 994, 64 Stat. 906 *et seq.*), charitable organizations that carried on ordinary trades or businesses were able to escape tax on their profits on the theory that the charitable "destination" of the revenues took precedence over their commercial "source." Thus, a nationwide vendor of macaroni (*C.F. Mueller Co.* v. *Commissioner*, 190 F.2d 120 (3d Cir. 1951)), and a commercial bathing beach facility (*Roche's Beach, Inc.* v. *Commissioner*, 96 F.2d 776 (2d Cir. 1938)), successfully claimed tax-exempt status simply because their business profits went to charity.

In 1950 Congress responded to this problem in two ways. First, it enacted the so-called "anti-feeder" provision (I.R.C. § 502(a)), under which organizations "op-

erated for the primary purpose of carrying on a trade or business for profit" cannot claim tax exemption solely on the ground that their profits go to charity. Second, Congress enacted the "unrelated business income tax," now codified in Sections 511 through 515 of the Code. Those provisions generally require any organization that otherwise qualifies for tax exemption to pay tax at regular corporate rates on income derived "from any unrelated trade or business * * * regularly carried on by it" (I.R.C. § 512(a)(1)).

The chief impetus behind the new tax was Congress's desire to put the business operations of tax-exempt organizations on an equal footing with those of their tax-paying commercial counterparts. The House report stated that "[t]he problem at which the tax on unrelated business income is directed * * * is primarily that of unfair competition." H.R. Rep. 2319, 81st Cong., 2d Sess. 36 (1950). As amended in 1950, the Code "does not deny [a tax] exemption where the organizations are carrying on unrelated active business enterprises, or require that they dispose of such businesses, but merely imposes the same tax on income derived therefrom as is borne by their competitors" (*id.* at 37).

The unrelated business income tax, as enacted in 1950, did not include a definition of the term "trade or business." The legislative history, however, made clear that the term "has the same meaning as it has elsewhere in the code, as, for example, in [the predecessor of Section 162(a)]," which authorizes deductions for expenses incurred "in carrying on any trade or business." See H.R. Rep. 2319, *supra*, at 109; S. Rep. 2375, 81st Cong., 2d Sess. 106 (1950). Under Section 162(a), "[i]t is well established that the existence of a *genuine profit motive* is the most important criterion for the finding that a given course of activity constitutes a trade or business." *Lamont* v. *Commissioner*, 339 F.2d 377, 380 (2d Cir. 1964) (emphasis added).

In 1967, the Treasury promulgated regulations defining a "trade or business" for purposes of the unrelated business income tax. Treas. Reg. § 1.513-1, 32 Fed. Reg. 17657 (1967). The regulations explained that any activity "which is carried on for the production of income and which otherwise possesses the characteristics required to constitute [a] 'trade or business' within the meaning of section 162 * * * presents sufficient likelihood of unfair competition to be within the policy of the [unrelated business income] tax" (Treas. Reg. § 1.513-1(b)). "Accordingly," the Treasury concluded, "for purposes of section 513 the term 'trade or business' has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services" (*ibid.*).

In an effort to resolve the controversy spawned by these regulations, Congress in 1969 codified the Treasury's definition of "trade or business" (Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 *et seq.*). Congress explicitly stated its intention "to make clear that such regulations are valid" and its determination that they "should be placed in the tax laws." H.R. Rep. 91-413, 91st Cong., 1st Sess. Pt. 1, at 44 (1969); S. Rep. 91-552, 91st Cong., 1st Sess. 75 (1969). Effectuating that aim, Congress in 1969 added to the Code a new Section 513(c). It provides that, "[f]or purposes of this section, the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services."

b. The unalloyed language of Section 513(c) makes plain the error of the Federal Circuit. The Endowment's insurance operations obviously comprised both "the sale of goods" and "the performance of services." It sold various insurance products at retail, and it performed valuable services by putting together a group of above-average insureds, negotiating with underwriters, assembling a package of group policies, marketing that package to its members, collecting its members' pre-

miums, and discharging countless other day-to-day administrative tasks. Indeed, its staff of 40 ran the business in much the same way that most insurance brokers, plan administrators, and other financial intermediaries run theirs. Equally obviously, the Endowment carried on its insurance operations "for the production of income." Both courts below found that the Endowment's insurance operations were unusually profitable and were consciously structured to be so, since it set its retail premiums far above its wholesale cost so as "to maximize dividends" and thus maximize profits (App., *infra*, 4a). In holding that the Endowment's insurance activities were not a "trade or business," the Federal Circuit simply ignored the language of the statute.

Given the language of the statute, the Federal Circuit's notion that the "phenomenal" and "astounding" profitability of the Endowment's insurance operations *negated* their trade-or-business status (App., *infra*, 8a) seems almost whimsical. The key criterion for assessing the existence of a "trade or business" under Section 513(c) is the presence of a profit-making motive. One would have thought that a motive, successfully executed, to make extraordinarily large profits would make an activity more of a "trade or business," not less of one.

This common-sense thought is consistent, not only with the statutory language, but with the economic facts. Economically speaking, the Endowment's insurance operations function as a business set up to exploit a very valuable, but virtually cost-free, asset—a pool of potential insureds, all ABA members, who have far-above-average mortality and morbidity experience. The Endowment could elect to exploit this asset in at least two ways, depending on its marketing strategy. It could charge below-market premiums, maintaining a modest level of profitability per insured but attracting a big market share. If it did that, many more lawyers would presumably join the ABA and buy insurance from the Endowment, since its premiums would be among the lowest available anywhere. If the Endowment chose to run its

insurance business in that way, it would make its profits (as do supermarkets) on volume, and would clearly—even under the decision below—have to pay unrelated business income tax on those profits.

Alternatively, the Endowment could elect, as it in fact did, to charge market-level premiums, maintaining a very high level of profitability per insured but settling for a more modest market share. On this approach, many lawyers might decide to buy insurance elsewhere, the Endowment's prices being roughly equivalent to those charged in the marketplace generally. But the Endowment would make lots of money on the lawyers who picked it. That is what the Endowment chose to do, and it should pay tax on its insurance income just as clearly as if it had chosen the high-volume, low-mark-up option discussed above.

Contrary to the conclusion of the courts below, finally, it is immaterial that the Endowment, in marketing its insurance, described its solicitations as "fundraising," or that the funds raised were channeled to the Endowment's educational projects (App., *infra*, 8a, 35a). Whenever a charity raises money, from an unrelated business or otherwise, its activity can be styled "fundraising," since the income is destined for—indeed, must, if the charity is to retain its tax exemption, be used exclusively for—charitable purposes. The profits NYU once derived from its macaroni factory (*C.F. Mueller Co.* v. *Commissioner*, *supra*) could equally have been labeled "fundraising," for the funds financed education. That is what prompted Congress to enact the unrelated business income tax in 1950, determining that tax-exempt groups should not be granted a tax subsidy at the expense of their taxpaying competitors in the marketplace, and enacting a statute that focuses on the *source*, not on the *destination*, of a tax-exempt organization's income. The rationale of the courts below—that the Endowment's insurance profits represented "charitable fund-raising"—simply begs the question, which is not whether the Endowment raised

funds for charitable purposes, but whether it raised funds for those purposes by running a "trade or business." As commentators on the Claims Court's decision have succinctly noted, "the court's emphasis on the destination of the profits for charitable purposes is wholly at variance with the genesis of the tax." Schwarz & Hutton, *Recent Developments in Tax-Exempt Organizations*, 18 U.S.F.L. Rev. 649, 684 (1984).

3. The question presented has considerable administrative importance. Group insurance plans are popular revenue-raisers for tax-exempt organizations. The IRS advises that in recent years it has issued dozens of private letter rulings responding to requests for guidance about the application of the unrelated business income tax to the insurance operations of tax-exempt groups. A preliminary IRS survey discloses 37 open or recently-closed audits involving this issue. Considering bar associations alone, a 1982 study by the Endowment (C.A. App. 1188) revealed that 90% of state bars offer group life, medical, and disability insurance, and that most large local bar associations sell various types of insurance as well.

The reasoning of the decision below could be pressed into service by hundreds of educational groups, fraternal societies, business leagues, and other tax-exempt membership associations nationwide. Under the court of appeals' theory, any group whose members are blessed with better-than-average health or longevity can offer group insurance at prevailing market rates without paying tax on its profits. As this case illustrates, these profits tend to be large, and the taxes at stake—for the Endowment, over $6 million for the three years at issue—concomitantly substantial.

There is, moreover, no principled basis for confining the court of appeals' reasoning to insurance activities. Tax-exempt associations could operate vacation resorts, catalogue shopping centers, apartment houses, or any other profit-motivated enterprise for their members. So

long as they contrive to make extraordinarily large profits, and publicize to their members the charitable destination of those profits, they would seem under the Federal Circuit's reasoning to be as well situated as respondent to claim immunity from tax on their business receipts.

Aside from the revenue impact, the question presented is important because the unrelated business income tax has a significant regulatory function. Congress designed the tax, not just to raise money, but to keep the commercial endeavors of tax-exempt and non-exempt competitors on a par. The Endowment offers insurance at market prices and enjoys the patronage of some 57,000 ABA members. It competes directly with insurance brokers, plan administrators, and underwriters nationwide who vie for the business of those 57,000 lawyers. The fact that the Endowment elected to limit its market share by forbearing to underprice its competitors does not mean, as the Claims Court thought (App., *infra*, 48a), that its insurance business has "an entirely procompetitive effect." Quite the contrary: a tax-exempt group need not undersell everyone else in the market to run afoul of the policy of the unrelated business income tax. It must be rather cold comfort to respondent's competitors that respondent's insurance could be even cheaper than it is. Particularly is that so when the Endowment exploits its standing as a charitable organization to its commercial advantage by telling its members that their premiums are tax-deductible.

4. As noted earlier, the question presented here concerning the unrelated business income tax is connected to that on which the Court has granted certiorari in *United States* v. *American College of Physicians*, No. 84-1737 (July 1, 1985). The question in that case is whether a tax-exempt group's publication of commercial advertising, which it concedes to be a "trade or business," is "substantially related" to its educational purposes. The question here, by contrast, is whether a tax-exempt group's conduct of insurance operations, which it con-

cedes not to be "substantially related" to its educational purposes, is a "trade or business." The two questions, while obviously linked, involve the construction of different statutory phrases, appearing in different provisions of the Code, each illuminated by a unique legislative history, and each accompanied by a long and discrete tradition of judicial interpretation. This Court's decision in *United States* v. *American College of Physicians*, *supra*, therefore, is most unlikely to resolve the question of statutory construction presented here. For the reasons outlined above, that question merits this Court's plenary review.

B. Frederic D. Turner, et ux., et al.

1. Section 170 of the Code affords an income tax deduction for a "charitable contribution," defined as "a contribution or gift" to or for a charitable, educational, or other qualifying organization (I.R.C. § 170(c)(2)). The phrase "contribution or gift" is not further defined in the Code or Regulations. However, Congress made clear in the legislative history of the 1954 Code that a transfer of property constitutes a contribution or gift "only if there [is] no expectation of any *quid pro quo*." H.R. Rep. 1337, 83d Cong., 2d Sess. A44 (1954). For purposes of the charitable contribution deduction, in other words, "gifts" are limited to "those contributions which are made with no expectation of a financial return commensurate with the amount of the gift." S. Rep. 1622, 83d Cong., 2d Sess. 196 (1954).

Drawing upon this legislative history, the courts of appeals have consistently denied charitable contribution deductions to taxpayers who expect to receive, or do receive, an economic *quid pro quo* commensurate with the value of the property they transfer to charity. In *Sedam* v. *United States*, 518 F.2d 242 (1975), the Seventh Circuit denied a charitable deduction for a donation to an old-age home, where the "gift" was required as a condition of admitting patients. "It is at least clear," the court held, "that a payment is not a contribution or gift

under section 170 if it is made with the expectation of receiving a commensurate benefit in return" (518 F.2d at 245). In *Stubbs* v. *United States*, 428 F.2d 885 (1970), the Ninth Circuit upheld the denial of a charitable deduction for a developer's contribution of land to a municipality, where the transfer was made in the hope of obtaining favorable zoning treatment. The "gift" did not qualify for deduction under Section 170, the court held, because it "was in expectation of the receipt of certain specific direct economic benefits" (428 F.2d at 887). Indeed, the Federal Circuit's predecessor on previous occasions itself denied charitable deductions where "the transferor has received, or expects to receive, a *quid pro quo* sufficient to remove the transfer from the realm of deductibility under section 170." *Singer Co.* v. *United States*, 449 F.2d 413, 423 (Ct. Cl. 1971).

2. Consistently with these well-established principles, the Claims Court in the instant cases held that respondents were not entitled to deduct their insurance premiums as "charitable contributions" unless they could show that, in purchasing insurance from the Endowment, they had "bought goods or services for more than their economic value, with the intention that the excess be used to benefit a charitable enterprise" (App., *infra*, 49a). Since respondents testified that they regarded the Endowment's insurance package as "reasonably or competitively priced" (C.A. App. 430), and since none of the respondents proved that he knew of a less-expensive insurance package available anywhere else, the Claims Court concluded that each had failed to show that he "purchased [the Endowment's] insurance for reasons other than his own economic interest" (App., *infra*, 54a). In short, because respondents failed to prove that the premiums they paid exceeded the fair market value of the insurance they bought, they were not entitled to charitable contribution deductions, having received, as they had expected to receive, "a financial return com-

mensurate witl. the amount of [their] gift[s]" (S. Rep. 1622, *supra*, at 196).

3. In reversing the judgment of the Claims Court, and in rejecting the legal standard it adopted, the Federal Circuit's decision is squarely at odds with fundamental tax principles enunciated by Congress and confirmed by other courts of appeals. The court below completely ignored the economic comparability between what respondents paid for and what they got. Instead, it adopted a vague and subjective standard mandating inquiry into "whether the relationship between the Endowment and the [respondents] was predominately of a business nature" (App., *infra*, 22a-23a). Under that standard, the Federal Circuit ruled, respondents on remand could "present a *prima facie* case for the deduction * * * simply [by] mak[ing] a sworn assertion that they wanted to aid [the Endowment's] charitable endeavor and entered the Endowment's plan because it enabled them to do so" (*id.* at 22a). The burden of proof, the court said, would then shift to the government to "controvert that position and suggest factors showing that the transaction was basically business-oriented" (*ibid.*).

The court of appeals' reasoning is multiply flawed. It is contrary to the numerous cases holding that "a payment is not a contribution or gift under section 170 if it is made with the expectation of receiving a commensurate benefit in return" (*Sedam* v. *United States*, 518 F.2d at 245). Far from making out a prima facie case for a deduction, the self-serving affidavit contemplated by the court of appeals is entitled to no probative weight. Such an affidavit would sidestep the real question, which is not whether respondents bought insurance from the Endowment because they "wanted to aid [its] charitable endeavor" (App., *infra*, 22a), but whether they enrolled in its program with "no expectation of any *quid pro quo*" (H.R. Rep. 1337, *supra*, at A44). Tax cases, moreover, are no exception to the rule, acknowledged from time immemorial, that the plaintiff

bears the burden of proof. *Helvering* v. *Taylor*, 293 U.S. 507, 514-515 (1935); *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933). Indeed, even "[a]fter satisfying the procedural burden of producing evidence to rebut the presumption in favor of the Commissioner, the taxpayer must still carry his ultimate burden of proof or persuasion." *Rockwell* v. *Comissioner*, 512 F.2d 882, 885 (9th Cir. 1975). The court of appeals' proposed affidavit procedure encroaches impermissibly on these long-settled rules.

Contrary to the court of appeals' belief, finally, the fact that respondents may be said to have "approv[ed] of and consent[ed] to" the Endowment's insurance program (App., *infra*, 8a) by agreeing to waive their entitlement to policy dividends makes no difference in determining whether they are entitled to charitable contribution deductions. Respondents, like all other ABA members, have absolutely no choice in this respect. If they will not waive their dividends, they cannot get insurance; it is simply part of the price of admission. The Endowment sets its price of admission fully cognizant of the valuable function it performs by assembling a pool of better-than-average insurance risks and negotiating favorable contracts with its underwriters. That in turn enables the Endowment to make big profits while keeping its retail price competitive. Many lawyers elect to pay that price because they cannot find a better deal elsewhere. The simple fact of the matter is that ABA members do not have access to the wholesale group insurance market, but must pay the retail price, and the Endowment in this respect charges whatever the retail market will bear. Respondents got what they paid for—insurance at market prices—and they accordingly have no claim to any charitable contributions.

4. Because the Federal Circuit remanded the individual respondents' cases with instructions to the Claims Court, the court of appeals' decision on the "charitable contribution" question is interlocutory. That issue is nevertheless suitable for this Court's immediate review.

It presents a clear-cut question of law, resolution of which is essential to the proper conduct of proceedings (if any) on remand. It is closely linked to the unrelated business income tax question presented in *American Bar Endowment*, as to which the Federal Circuit's judgment is final. The two questions draw on a common nucleus of facts, and the legal analysis brought to bear on the one may well illuminate the proper approach to be taken to the other. Indeed, in light of the Federal Circuit's description of the Endowment's insurance operations as "a fund-raising program" (App., *infra*, 2a), the two questions, in a sense, are reverse sides of the same coin, requiring analysis of the insurance transaction from the seller's and the buyer's viewpoint respectively. The charitable contribution question has considerable importance, potentially involving $1.5 million in annual revenue and tax deductions of some 57,000 taxpayers in these cases alone. The court of appeals has stayed proceedings on remand pending disposition of this petition, and considerations of judicial economy favor resolution of the charitable contribution question now.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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OCTOBER 1985

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

Appeal No. 84-988

AMERICAN BAR ENDOWMENT, APPELLEE

v.

THE UNITED STATES, APPELLANT

Appeal No. 84-1000

FREDERIC D. TURNER, ET UX.,
ARTHUR SHERWOOD, ET UX., ET AL., APPELLANTS

v.

THE UNITED STATES, APPELLEE

Decided: May 10, 1985

Before FRIEDMAN, DAVIS, and BENNETT, *Circuit Judges.*

DAVIS, *Circuit Judge.*

These are consolidated appeals from the decision of the United States Claims Court, Kozinski, *C.J.*, in *American Bar Endowment* v. *United States*, 4 Cl. Ct. 404 (1984). In No. 84-988, the Government appeals from that portion of the ruling which held that appellee American Bar Endowment (the Endowment) earns no unrelated business taxable income from a fund-raising program in which the Endowment obtains a group insurance policy for its members and keeps (by assignment) the refunded dividends which accrue. In No. 84-1000, participating members of the Endowment (the individual taxpayers) appeal from the Claims Court's decision that they may not deduct the premium dividends (which they assign to the Endowment) as charitable contributions. In No. 84-988, we affirm; in No. 84-1000, we reverse and remand for further proceedings in accordance with this opinion.

I.

Background

The American Bar Endowment is a charitable organization the purpose of which is to support educational projects and research in the legal field. The Endowment is the principal source of funds for the American Bar Foundation, a research organization under the aegis of the American Bar Association (ABA). Although all members of the ABA are automatically members of the Endowment, the two organizations are separate legal entities. Because the Endowment is devoted to furthering educational projects, the Internal Revenue Service (IRS) has

determined that it is exempt from taxation under 26 U.S.C. § 501(c)(3) (1982).[1]

In the early 1950's the Endowment established the insurance plan which is the crux of these cases. In the now-pertinent particulars the plan is similar to any insurance program in which a central organization holds a group policy for which the organization's members pay a portion of the premium reflecting the amount of coverage they desire. In order to participate in the Endowment's plan, however, a member must assign to the Endowment all dividends to which he or she might be entitled. These dividends represent the difference between the premiums paid by the participants and the actual cost of coverage to the insurance company in terms of claims settlement, administrative expenses, and profits. *Cf. Penn Mutual Life Ins. Co.* v. *Lederer*, 252 U.S. 523, 525 (1920) ("It is the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policyholder.") Members who refuse to assign their right to the dividends are, according to the terms of the plan, not entitled to participate. The terms of the assignment are plainly set forth above the signature line in the contract between the participant and the Endowment.

During the period at issue here (tax years 1979-1981), the Endowment purchased policies from two insurance companies: New York Life Insurance Co. (a life insurance policy) and Mutual of Omaha Insurance Co. (other policies, *e.g.*, major medical and disability income insurance). The Endowment purchased the policies through a broker, James Group

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[1] All further statutory citations are to this edition of title 26, the Internal Revenue Code of 1954, as amended.

Service, Inc. The insurance companies paid the broker a small percentage of the premiums as a commission.

The Endowment took sole responsibility for arranging the terms of the insurance, including the premiums and terms of coverage. Because the Endowment sought to maximize dividends, it had an incentive to set the premiums as high as possible without discouraging participation. The Endowment therefore set the premium at a level competitive with other insurance on the market; what the Endowment hoped is that it would benefit from the high dividends it could recoup as a result of the generally favorable morbidity and mortality experience of the attorney participants. This strategy has been extraordinarily successful. In the twenty-eight years from its inception to the time of this suit, the plan has grown from 12,000 to 55,000 participants. During this period the Endowment has recouped $81.9 million in dividends, of which it has distributed $63 million for educational projects. Currently, the Endowment employs approximately 40 people to administer the insurance plan.

Each year in which the Endowment receives a dividend on a group policy, which is more often than not, the Endowment notifies the participants as to the percentage of the total premium paid on that policy which it subsequently recouped as a dividend. These percentages are often as high as 30-40 percent, and sometimes 50 percent or over. Along with the notice, the Endowment advises participants that, in its opinion, that portion of the individual participant's payment which the Endowment received as part of the dividend is a tax deductible charitable contribution for the participant. As the prospect of litigation arose, the Endowment has included in the annual

notice a caveat to the effect that the IRS does not necessarily share its views.

These cases present two issues for our resolution. First, do the dividends which the Endowment receives from the insurance companies fall within the provisions concerning the taxation of the unrelated business income of otherwise tax-exempt organizations (such as the Endowment)? Second, are the participants in the Endowment's insurance plans entitled to deduct from their gross income that portion of their insurance payments which the Endowment recoups in dividends? We deal with these questions in the context of the separate appeals to which they pertain.

II.

The Government's Appeal—Taxability of the Endowment

A.

Congress has placed several provisions in the tax laws which grant beneficial treatment to charitable contributions. Of central importance are the tax forgiveness provisions in sections 170 and 501. Section 170(a), with exceptions and limitations not relevant here, authorizes taxpayers to deduct the value of charitable contributions from their gross income, thus allowing charitable donors to avoid taxation on that amount. Section 501(a) correspondingly exempts charitable organizations from taxation on the donations they receive. Under this arrangement, donations to charity are never taxed, either in the donor's hands or in the charity's pocket.

In the Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 947, Congress modified this scheme to insure that a charitable organization does not engage in a

commercial enterprise and thus take unfair advantage of its tax-exempt status to the detriment of competing businesses subject to taxation. The statute created an unrelated business income tax (unrelated business tax) on the income that a charitable organization receives from a trade or business unrelated to its charitable purpose.[2] *See* sections 511(a)(1), 512(a)(1). The term "unrelated trade or business" (for the purposes of this tax) means

> any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance of such organization of its . . . purpose or function constituting the basis for its exemption under section 501.

Section 513(a). In the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 941, Congress clarified the meaning of "trade or business": "For the purposes of this section, the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services." Section 513(c).

The regulations interpreting section 513 set forth a three-part test for determining whether a charitable organization's activity generates income subject to the unrelated business tax:

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[2] *See* S. Rep. No. 2375, 81st Cong., 2d Sess. (1950), *reprinted in* 1950 U.S. Code Cong. Serv. 3053, 3081 ("The problem at which the tax on unrelated business income is directed is primarily that of unfair competition."); Treas. Reg. § 1.513-1(b), 26 C.F.R. § 1.513-1(b) (purpose of unrelated business tax is to put "the unrelated business activities of certain tax exempt organizations on the same tax basis as the nonexempt business endeavors with which they compete").

> [G]ross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Treas. Reg. § 1.513.1(a), 26 C.F.R. § 1.513-1(a) (1984). By stipulation of the parties, only part (1) of this test—whether the Endowment carries on a trade or business by conducting the insurance plan—is at issue in the case regarding the Endowment's tax liability.

B.

In a technical advice memorandum dated July 3, 1980, the IRS informed the Endowment that, in the IRS' opinion, the insurance plan is an "unrelated trade or business" within the meaning of the statutory provisions imposing the unrelated business tax, and that the dividends constitute taxable income. The IRS reasoned that the Endowment sells its services as a group policyholder, without which its members could not enjoy the benefits of the plan's group rates. *See* G.C.M. 38940 (April 15, 1982), *reprinted in* [1982-1983 Transfer Binder] IRS Positions Rep. ¶ 1127 (for a full exposition of the IRS' reasoning). Based on this conclusion, the IRS conducted an audit and assessed a deficiency against the Endowment for the tax years 1979 and 1980, plus interest on the 1980 payment.[3] This was paid. The Endowment also

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[3] The record is unclear as to why the IRS assessed no interest on the 1979 deficiency.

paid taxes on the dividends it received in 1981. On July 15, 1982 the Endowment filed a claim with the IRS for a refund of these payments. The IRS disallowed the claim on August 6, 1982. This refund suit followed and trial was held, resulting in factual findings and legal rulings.

In its opinion, the Claims Court undertook the rigorous task of parsing the relevant statutory provisions. As to the Endowment, the court deemed the appropriate query to be whether the Endowment "is 'operated in a competitive, commercial manner'." 4 Cl. Ct. at 409 (quoting *Disabled American Veterans* v. *United States*, 650 F.2d 1178, 1187, 227 Ct. Cl. 474 (1981) (*per curiam*). If the insurance plan was found to be similar to a commercial, profit-making enterprise, the plan would fit within the definition of "trade or business" set forth in section 513(c) and the dividends would be income subject to taxation under the unrelated business provisions. Otherwise, they would merely be accumulated charitable funds and not subject to taxation.

The court concluded that the relevant facts and factors—which have been found here—including the Endowment's phenomenal success (particularly the astounding proportion of its gross premiums recouped as dividends); the persistent and fundamental fund-raising motivation of the program; and the knowledgeable approval of and consent to the program by the ABA's members—compelled the conclusion that the Endowment does not operate in a competitive, commercial manner. 4 Cl. Ct. at 410-11. Moreover, noting that section 513(c) of the unrelated business provisions requires taxation only of that income derived "from the sale of goods or the performance of services", the court determined that the

Endowment's receipts have far exceeded the value of any services which it might have performed in the course of its administration of the plan, and thus did not fit within the statutory definition of income from a trade or business. *Id.* at 411. Finally, the court noted that Congress' primary purpose in enacting the unrelated business income tax was to compensate for the unfair advantage that tax-exempt organizations have when they compete in the marketplace with commercial enterprises. Because (1) the Endowment employs commercial underwriters and brokers rather than performing these functions itself, and (2) the Endowment seeks to raise the price of its insurance rather than undersell other plans, the Claims Court held that the Endowment does not effectively compete with commercial, taxable insurance businesses, and therefore does not represent the sort of enterprise at which the unrelated business income tax provisions are directed. *Id.* at 413-14.

C.

In No. 84-988, we affirm on the basis of Chief Judge Kozinski's opinion that portion of the decision below which held that administration of the insurance plan does not constitute an unrelated trade or business to which the unrelated business tax applies. The court applied the correct standard for determining whether the plan is a "trade or business" under section 513(c), properly found facts, and identified appropriate and convincing reasons for concluding that the Endowment did not meet the "competitive" and "commercial" criteria of *Disabled American Veterans*. We add only a few words in response to some of the Government's arguments on this appeal.

The Government considers this case to be identical to cases from other courts involving the application of the unrelated business provisions to group insurance plans. The three decisions which the Government cites are *Professional Insurance Agents of Michigan* v. *Commissioner*, 726 F.2d 1097 (6th Cir. 1984); *Carolinas Farm & Power Equipment Dealers* v. *United States*, 699 F.2d 167 (4th Cir. 1983); and *Louisiana Credit Union League* v. *United States*, 693 F.2d 525 (5th Cir. 1982). Chief Judge Kozinski found these cases to be inapposite, primarily because they involved insurance plans run by business leagues rather than charitable organizations. He reasoned that, because donations by members to the organization are business deductions and not charitable contributions, the receipts from their insurance plans could not be charitable contributions but must be income. We note an additional ground for distinguishing these cases: the business leagues received a stipend from the insurance companies for services provided to these companies, and not merely experience dividends which their members allowed them to keep. Their profits therefore fell within the definition of "trade or business" ("income from the . . . performance of services") contained in section 513(c). Furthermore, the business leagues, in performing these services, directly competed with commercial enterprises—such as James Group Service, the Endowment's broker—a situation in which Congress said the unrelated business tax should be imposed. S. Rep. 2375, *supra*; *see also* Treas. Reg. § 1.513-1(b), *supra*; *Disabled American Veterans*, 650 F.2d at 1181 & n.4.

The Government also argues that the very factors evaluated by the Claims Court establish that the Endowment operated in a competitive, commercial man-

ner. We are directed particularly to the fact that the Endowment set its rates "with reference to the rates for other insurance available in the market" and thereby maximized its receipts, *i.e.*, the Endowment set out to make as much "profit" as possible. 4 Cl. Ct. at 406. The Government concludes that this objective is characteristic of a commercial enterprise and results in direct competition with other group insurance services. Unlike what some other courts may do, this court does not find "profits," or the maximization of revenue, to be the controlling basis for a determination of whether the unrelated business tax provisions apply.[4] We consider not only the amount of money the charitable organization receives, but the source and character of these funds. In this connection the Claims Court specifically and permissibly rejected the Government's contention that the dividends represent a payment for the Endowment's services.[5] Because the Endowment's accumulation of funds was not the result of a commercial exchange, we agree with the Claims Court's view that the dividends do not constitute "profits" which fall within the defini-

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[4] *Compare, e.g., Louisiana Credit Union League*, 693 F.2d at 532 (intent to earn a profit determinative), *with Iowa State Univ.* v. *United States*, 500 F.2d 508, 517-18, (1974) (profits are evidence of a commercial purpose, but not conclusive).

[5] *Compare Disabled American Veterans*, 650 F.2d at 1187-88 ($5 contribution viewed as payment in exchange for trinket of substantial value); *Steamship Trade Assn. of Balto.* v. *Commissioner*, 81 T.C. 303, 312 (1983) ("Petitioner [a business league which administers its members' employee vacation and annual income funds] clearly sells a service for which it receives a substantial sum of money")), *aff'd*, No. 84-1099 (4th Cir. March 27, 1985).

tion of section 513(c).[6] A charity should not be subject to taxation merely because its charitable solicitations are successful. This would, however, be the result if we adopted the IRS' reasoning in this case.

III.

The Taxpayer's Appeal—Deductible Charitable Contributions

A.

The taxpayers' appeal concerns the effect of section 170 on the agreement to assign dividends to the En-

[6] On the conclusion reached below, which we accept, our refusal to view the recouped dividends as payment for the Endowment's services is consistent with the IRS' own memoranda. In G.C.M. 38940 (April 15, 1982), *reprinted in* [1982-1983 Transfer Binder] IRS Positions Rep. (CCH) ¶ 1127 at 3444, the IRS stated that a group policy holder such as the Endowment "serves as group policyholder *in exchange for which* the individual insured members agree to pay premiums and irrevocably assign their share of the premium refunds." (Emphasis in original.) In G.C.M. 38955 (June 29, 1982), *reprinted in* [1982-1983 Transfer Binder] IRS Positions Rep. (CCH) ¶ 1157, the IRS stated that a similar plan did not subject a charitable organization to taxation if it offered to distribute the dividends to those participants who so requested. The IRS concluded that the offer of a rebate negated the presumption that the dividend was consideration for the organization's services. In the present case, the Claims Court specifically found that the assignment of dividends was not an exchange for services, but rather reflected the intention of the membership to support the Endowment's charitable activities. This case therefore falls within the rule of G.C.M. 38955, rather than G.C.M. 38940. In any event, we fail to see how one plan competes any less with commercial group insurance plans than the other. If any difference exists, the plan which offers to distribute the dividends presents the greater possibility of competition with taxed organizations.

dowment. Section 170(a) provides: "There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year." Section 170(c) provides only that a contribution is a "contribution or gift to or for the use of" certain types of organizations, of which the Endowment is one. The only real clue as to what Congress intended by the term charitable contribution is a comment regarding section 162(b),[7] in which Congress said that charitable contributions are donations "made with no expectation of a financial return commensurate with the amount of the gift." H. Rep. No. 1337, 83d Cong., 2d Sess. (1954)), *reprinted in* 1954 U.S. Code Cong. & Ad. News 4018, 4180; S. Rep. No. 1662, 83d Cong., 2d Sess. (1954), *reprinted in id.* at 4621, 4831. The issue on the taxpayers' appeal is whether the required payments of the dividends to the Endowment were deductible contributions.

B.

By a letter of August 7, 1980, the Endowment informed its members that, under a ruling which the Endowment had requested, the IRS, beginning in tax year 1980, would not allow participants to deduct under Section 170 the dividend portion of their insurance premiums recouped by the Endowment as charitable contributions. The individual taxpayers in this case, all of whom failed to deduct the portion of his dividend recouped by the Endowment in 1981, filed a claim for a refund. In each case, six months passed without a response from the IRS. They then filed a

[7] Section 162(b) provides that contributions which exceed the limitations of section 170 are not deductible as trade or business expenses.

timely complaint in the Claims Court which was consolidated with the Endowment's case. A trial was also held on the individual taxpayer's case.

The Claims Court recognized that a given transaction can possess dual characteristics, being at the same time a commercial transaction and a charitable contribution. The relevant question (according to the court) is the size of each of these components. Under the rule thought to guide such an inquiry, "the taxpayer must demonstrate that he bought goods or services for more than their economic value, with the intention that the excess be used to benefit a charitable enterprise." *Id.* at 415 (citing Rev. Rul. 67-246, 1967-2 C.B. 104, 105). If the taxpayer receives from the charity some recompense entirely commensurate with the value of the payment, then no dual payment situation arises because the charitable contribution portion of the payment is zero. In addition, under the Claims Court's formulation, the taxpayer must prove that the payment was accompanied by a specific intention to make a charitable contribution.

In an effort to determine the value of the compensation received by the participants in the Endowment's insurance plan, the Claims Court looked to the value of similar insurance plans available to each taxpayer. That was the critical test. In the Claims Court's eyes, three of the taxpayers failed to prove that they were eligible to participate in a cheaper insurance plan; they thus failed to establish the charitable contribution component of their payments. One taxpayer demonstrated that he was eligible for cheaper insurance, but he failed to state that he knew of that insurance during the years in issue; the court found that he therefore failed to establish the requisite intent to make a charitable contribution. All the individual claims were thus disallowed.

C.

The taxpayers' case is unusual. Neither side has cited, nor have we found in our research, any case in which the issue was the deductibility under section 170 of an assignment of insurance dividends to a charitable organization which held the group insurance policy. On appeal, the Government argues that the Claims Court's decision correctly placed the burden of proving a charitable motive—which the Government argues is the *sine qua non* of a deduction under section 170—on the taxpayers. The Government also defends the court's particular method of determining charitable motive. We hold, however, that well established principles of tax law from this circuit and elsewhere require that we reject the unitary approach of the court below and remand for consideration in accordance with those principles as they should be applied to this unique situation.

As noted *supra*, the tax code does not expressly define the term "charitable contribution." We can make some headway, however, by determining what a charitable contribution is not. First and foremost, a charitable contribution is not an exchange. In *Singer Co.* v. *United States*, 449 F.2d 413, 196 Ct. Cl. 90 (1971), the Court of Claims established that a donation is not deductible if the donor anticipates substantial economic benefit from the act. The court stated:

> It is our opinion that if the benefits received. [*sic*] or expected to be received, are substantial, and meaning by that, benefits greater than those that inure to the general public from transfers for charitable purposes (which benefits are merely *incidental* to the transfer), then in such case we feel the transferor has received, or expects to receive, a *quid pro quo* sufficient to re-

> move the transfer from the realm of deductibility under section 170.

Id. at 423 (emphasis in original); *accord, Ottawa Silica Co.* v. *United States*, 699 F.2d 1124, 1132 (Fed. Cir. 1983) (*per curiam*) ("The plain language [of *Singer*] clearly indicates that a 'substantial benefit' received in return for a contribution constitutes a *quid pro quo*, which precludes a deduction.")

In *Singer*, the taxpayer sold sewing machines to schools at bargain prices with the (unrealized) expectation that those trained on Singer machines would later purchase Singer products. In *Ottawa Silica*, the taxpayer donated a parcel of land to a school district in anticipation of increasing the value of its surrounding holdings, which the taxpayer planned to divide into residential lots. In each case the court ruled that the expectation of future benefits removed the donation from the term "charitable contribution" as used in section 170.

On the other hand, the courts and the IRS have recognized that, as a practical matter, one can transact business with a charitable organization in such a way that the *quid pro quo*, though more than "*incidental* to the transfer" under the *Singer* test, is never expected by either party to the transaction to have a substantial bearing on the amount of the gift. An oft repeated situation is the purchase of tickets to charitable functions (*e.g.*, dinners), the return for which (the meal and any entertainment) is nowhere near the worth of the price of admission. The IRS has taken the position on many occasions that the donor is entitled to a deduction for the difference between the amount of the donation and the fair market value of whatever is received (or at least expected) in return. Rev. Rul. 67-246, 1967-2 C.B. 104 (price of tickets to charity ball deductible to the extent it exceeds the fair market value of attending the function); Rev. Rul. 76-185, 1976-1 C.B. 60 (agreement by which taxpayer agreed to refurbish an old house in exchange for use of the house for a term of years resulted in a deductible contribution to the extent that the renovation expenses exceeded the fair rental value of the property for the term of the lease). In Rev. Rul. 68-432, 1968-2 C.B. 104, 105, the IRS stated:

> Whenever the discrepancy between the size of the membership contribution and the potential monetary benefits is so great as to make it reasonably clear that the payment is of a dual character, the [IRS] will give due consideration to the possible separation on a uniform basis of that portion of the total payment that may properly be treated as a charitable contribution under section 170 of the Code.

The courts have also adopted this rule. *Marshall* v. *Welch*, 197 F. Supp. 874 (S.D. Ohio 1961) (donation to nursing home deductible in amount in excess of the cost of a wheelchair for donor's son purchased by the home); *Arceneaux* v. *Commissioner*, 36 T.C.M. (CCH) 1461, 1464 (1977) ("[T]o prevail, petitioners must show that the amount paid in 1972 to the [charity] exceeded the value of the services rendered by the adoption agency *and* that such excess was intended as a gift") (emphasis in original); *DeJong* v. *Commissioner*, 36 T.C. 896, 900 (1961), *aff'd*, 309 F.2d 373 (9th Cir. 1962) (deduction of contribution to school disallowed to the extent of the market value of education of taxpayer's children).

In Rev. Rul. 67-246, *supra*, the IRS set forth two conditions for proving a charitable component to a transaction in this context. First "an essential element is proof that the portion of the payment claimed as a gift represents the excess of the total amount paid over the value of the consideration paid therefor." 1967-2 C.B. at 105. The IRS recognized, however, that under this formulation a person who enters into a bad bargain with a charity (*i.e.*, the purchase price exceeds the fair market value of the property or services received) might attempt to deduct the difference as a charitable contribution. The IRS therefore ruled that evidence pertaining to the nature of the exchange is also critical:

> Another element which is important in establishing that a gift was made in such circumstances, is evidence that the payment in excess of the value received was made with the intention of making a gift. While proof of such intention may not be an essential requirement under all circumstances and may sometimes be inferred from surrounding circumstances, the intention to make a gift is, nevertheless, highly relevant in overcoming doubt in those cases in which there is a question whether an amount was in fact paid as a purchase price or as a gift.

Id. The Court of Claims imposed a similar standard in *Singer*; the court denied the deduction as to the sales to schools because Singer expected an important business *quid pro quo*, and the sales were thus "of a business nature and not charitable." 449 F.2d at 424. *Accord*, *Ottawa Silica*, 699 F.2d at 1132 (the nature of the arrangement in that case "effectively destroyed the charitable nature of the transfer.")

In *Rusoff* v. *Commissioner*, 65 T.C. 459 (1975), *aff'd*, 1977-1 USTC ¶ 9338 (2d Cir. 1977), the Tax Court considered the question whether an arrangement by which a group of inventors assigned to Columbia University one-half of their interest in a patent for a cigarette filter resulted in a deductible contribution by the inventors. Columbia agreed to investigate the development of the filter and defend the patent. The court looked to the circumstances surrounding the assignment, including "events surrounding the transfer and the legal documents executed by the parties," in an effort to "expose the true nature of the transaction." *Id.* at 469. The Tax Court concluded that "the evidence in its entirety . . . clearly shows that the transfer to Columbia was a business transaction, not a charitable contribution." *Id.*

D.

As we have pointed out, the Claims Court in the instant case concluded that these standards require a definite comparison between the cost of the Endowment's insurance plan and the cost of other plans available to the particular taxpayers—and also that the taxpayer has the burden of showing that the Endowment's plan is more expensive. The theory underlying this position is that, if the Endowment's insurance is the cheapest available, then the taxpayers' participation is "economically motivated, that is, where the payment is made to obtain goods or services for which the taxpayer would be willing to pay the full price even absent the charitable contribution." 4 Cl. Ct. at 415. Our difficulty with this comparison, as the precise litmus test of charitable vs. non-charitable transactions, is that it is an incorrect definitization of the proper standard.

First, the Claims Court's test requires that the taxpayers prove more than a charitable transaction, as *Singer* requires, but actually affirmatively prove a charitable motivation of disinterested generosity.[8] In *Singer*, however, the Court of Claims expressly rejected a pure motivational requirement, noting, *inter alia*, that this requirement places too harsh a burden on taxpayers. 449 F.2d at 421-22.

Second, the Claims Court's comparison can support the opposite conclusion from the one it draws. By comparing the cost of different plans, the court below failed to take into account the fact that, in other plans, the participants are entitled to their dividends. This lowers the net cost to them of the insurance. To the extent that it is relevant, this comparison can be said to indicate that the participants voluntarily forwent a right to which they would otherwise be entitled as a consequence of their participation in the plan.

Third, the Claims Court's overly-precise formulaic test assumes that all participants are purely "economic" persons, acting solely on a careful and detailed comparative investigation of pecuniary results and expectations. That is by no means a universal assumption and there are many who may be able to show that they made a charitable donation of the dividends to the Endowment, without proving that they deliberately and intentionally chose, after careful inquiry, the Endowment plan over other "better deals." In life, an intention to enter into a charitable transaction is often intertwined with other motivations, including some that are non-charitable.

[8] In particular, the Claims Court required that, to be deductible, the insurance plan must be a bad deal for the taxpayer, and the taxpayer must know that he could do better elsewhere. 5 Cl. Ct. at 417-18. This indicates a predominant motivational requirement of disinterested generosity, to be proved by the taxpayer.

Rather, the general question to be posed according to *Singer* and *Ottawa Silica* is whether the transaction between the Endowment and the taxpayers involving the assignment of dividends "was of a business nature and not charitable." 449 F.2d at 424. This determination must flow from an examination of all the pertinent circumstances surrounding the individual transaction—there is no single-factor test.[9] For instance, the record in this case shows that several participants in the Endowment's plan sought to evade or negotiate away the requirement that they assign the dividends. Some even sought to negotiate with the Endowment to remove the assignment clause from the contract.[10] A trial court might reasonably conclude that these individuals expected that the Endowment would provide the best possible insurance opportunity despite the assignment requirement; that this expectation colored the transaction and out-

[9] Taxpayers seem to say that the only test is whether the value of the services rendered by the charity is greater than or equal to the claimed charitable donation—and that in the present case it is clear that Endowment's services were worth much less than the assigned dividends. Like the Claims Court's single-factor formula, taxpayers' position has the advantage of simplicity but it flies in the face of the multi-faceted inquiry mandated by *Singer-Ottawa Silica* which looks at the entire transaction, including of course the factor of relative values, but also that of overall purpose, donative intent, etc.

[10] The tenor of a negotiation, indeed the fact of a negotiation itself, may indicate that the resulting agreement is of a business and not a charitable character. *Rusoff*, 65 T.C. at 471.

weighed other factors; that the transaction was therefore of a business and not a charitable nature; and that the taxpayer should be denied a deduction. On the other hand, many participants may have entered the Endowment's plan because of the notion that they could accommodate their insurance needs and at the same time substantially support a worthy charitable goal (and, indeed, generate a tax deduction). As to these individuals, a trial court might draw the exact opposite conclusion, and decide that a deduction is proper.[11] It should not be too difficult for participants of this latter type to present a *prima facie* case for the deduction. In the light of the Endowment's persistent and public efforts to enhance its charitable funds, it would be enough, until properly challenged, for participants simply to make a sworn assertion that they wanted to aid that charitable endeavor and entered the Endowment's plan because it enabled them to do so. The Government could, of course, controvert that position and suggest factors showing that the transaction was basically business-oriented.

As for the particular taxpayers involved in this case, the record is almost completely bare as to the nature of their dealings with the Endowment outside of the fact that they did indeed participate in the Endowment's plan and knew about the requirement to assign the dividends. We therefore reverse and remand for such further proceedings as are appropriate to determine whether the relationship between

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[11] For example, "The magnitude of the economic benefit conferred upon the charity is itself strongly probative of a donative intent." *Mason* v. *United States*, 513 F.2d 25, 27 n.9 (7th Cir. 1975) (*per* Stevens, *J.*).

the Endowment and the taxpayers was predominately of a business nature or whether the transaction did have a substantial charitable component.

For these reasons, No. 84-988 is affirmed and No. 84-1000 is reversed and remanded.

AFFIRMED IN PART, REVERSED AND REMANDED IN PART.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 84-988
465-82T et al.

AMERICAN BAR ENDOWMENT, APPELLEE

v.

THE UNITED STATES, APPELLANT

No. 84-1000
465-82T et al.

FREDERIC D. TURNER, ET UX.,
ARTHUR SHERWOOD, ET UX., ET AL., APPELLANTS

v.

THE UNITED STATES, APPELLEE

JUDGMENT

On Appeal from the United States Claims Court

This Cause having been heard and considered, it is Ordered and Adjudged: No. 84-988 is AFFIRMED and No. 84-1000 is reversed and remanded to the Claims Court consistent with the attached opinion.

DATED May 10, 1985

ENTERED BY
ORDER OF THE COURT

/s/ George E. Hutchinson
GEORGE E. HUTCHINSON
Clerk

Issued as a Mandate: June 6, 1985

APPENDIX C

IN THE UNITED STATES CLAIMS COURT

Nos. 465-82T, 163-83T,
190-83T, 320-83T,
351-83T

AMERICAN BAR ENDOWMENT,
FREDERICK D. TURNER ET UX.,
ARTHUR M. SHERWOOD ET UX.,
FREDERICK G. BOYNTON and
HERBERT C. BROADFOOT, II ET UX., PLAINTIFFS

v.

THE UNITED STATES, DEFENDANT

[Filed: Jan. 31, 1984]

OPINION

KOZINSKI, Chief Judge.

These consolidated cases present questions relating to the operation of group insurance plans by the American Bar Endowment (ABE), a tax-exempt charitable organization. In No. 465-82T, the question is whether operation of the plans is a trade or business and therefore subject to the Unrelated Business Income Tax (UBIT), 26 U.S.C. §§ 511-513 (1976 &

Supp. V 1981), or a fundraising activity and therefore not taxable. In Nos. 163-83T, 190-83T, 320-83T and 351-83T, the question is whether the individual plaintiffs are entitled to a charitable contribution deduction for dividends that were paid by the insurance companies under the ABE group plans and retained by ABE.

Facts [1]

A. *HISTORICAL BACKGROUND*

The American Bar Endowment is a charitable organization exempt from taxation under 26 U.S.C. § 501(c)(3) (1976). Its charitable purposes are to promote legal research and education in order to advance the administration of justice and the science of jurisprudence. The Endowment accomplishes its purposes by making grants and is the primary supporter of projects undertaken by the American Bar Foundation, the research arm of the American Bar Association. While all members of the ABA are automatically members of the Endowment, the Endowment is a separate legal entity.

The ABE was established in 1942, and ABA/ABE members were encouraged to contribute to it through gifts and bequests. By the early 1950's, however, it became clear that sporadic individual donations would not permit the Endowment to fulfill its objectives. To remedy this situation, a fundraising plan was proposed based upon the sale of group life insurance. Under this plan, the Endowment would make insurance available to its members at group rates. To

[1] The court made oral findings of fact on the record after trial. This opinion supplements those findings as appropriate to the resolution of the legal issues discussed.

participate in the plan, members would have to assign to the ABE any dividends or experience credits earned under the insurance policies.[2] The ABE group life insurance plan went into effect on June 1, 1955, with fewer than 12,000 subscribers.

From its modest beginnings, the ABE group insurance program has grown in size and importance. Over the years, the types of insurance and amount of coverage have increased, as have the insurance-related services performed by the Endowment staff. By the late 1970's and early 1980's, the period here in issue,[3] over 55,000 ABE members participated in the program, which was managed by a staff of about 40. Term life insurance of up to $150,000 was available, as was coverage for accidental death/dismemberment, major medical, in-hospital indemnity and disability income. Some insurance was also available for dependents under most of these policies.

During the years in issue, ABE's insurance program was underwritten by two companies, New York Life Insurance Co. (life programs) and Mutual of Omaha Insurance Co. (other programs). The Endowment employed James Group Service, Inc., a broker licensed by the state of Illinois, in connection with the purchase of insurance. The broker earned as commission a small percentage of all premiums. The commission was paid by the insurance companies but was in fact negotiated by ABE.

[2] Dividends or experience credits are portions of a year's premium that are refunded by the insurance company in light of its claims experience and other expenses. The concept is discussed at greater length below. *See* p. 3 *infra*.

[3] The tax years in issue are 1979, 1980 and 1981. Because the Endowment's tax year begins on July 1, the period in question in No. 465-82T is July 1, 1978, to June 30, 1981.

B. *THE INSURANCE PROGRAM*

1. *The Endowment's Strategy*

All of the insurance plans offered by ABE are of the participating type. Participating insurance offers the possibility that dividends or experience credits (hereinafter collectively "dividends") may be refunded to the insured at the end of each year. Whether dividends are paid in a given year depends upon two factors: the size of the premium initially collected (the initial or gross premium) and the costs incurred by the insurance company during the preceding year (principally with respect to the payment of claims). The larger the initial premium, the larger the expected dividend; similarly, the more favorable the claims experience, the larger the dividend.

Over the years, the Endowment sought to maximize the dividends received under the various insurance plans. It pursued this strategy by encouraging the insurance companies to set initial premiums as high as possible and by attempting to secure the lowest cost structure in the computation of dividends.

a. Maximizing Premiums. Setting the gross premium charged ABE members was technically the prerogative of the insurance companies. However, the companies always consulted with the Endowment, whose leadership had a significant role in determining premium rates. In general, the Endowment's leadership favored large initial premiums which could be expected to generate large dividends. The insurance companies generally favored lower gross premiums in order to attract the most participants.

While the Endowment sought to set gross premiums high, it did not do so blindly. The Endowment was aware that the level of premiums charged could

affect participation in the insurance programs. It therefore set premiums so as to maximize the total volume of dividends collected. This meant that gross premiums were set with reference to the rates for other insurance products available in the market.[4] In pursuit of this policy, Endowment staff reviewed other insurance products available to ABE members and compared them to those offered by the Endowment. Where appropriate, adjustments were made to keep the cost of ABE insurance more or less competitive. However, premiums were never set so as to make ABE insurance the best deal. Because of the low costs associated with ABE insurance, premiums could have been set much, much lower if maximizing participation had been the principal objective. It was the Endowment's policy, however, to operate only those insurance plans capable of generating substantial dividends in the long run.

b. Minimizing Costs. In addition to keeping premiums high, the Endowment did much to keep the costs attributable to Endowment insurance plans low. The most significant factor in lowering costs was to cause

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[4] Premiums, particularly for life insurance, were generally most competitive at younger ages and least competitive at older ages. This reflected two considerations. First, there was significant concern with bringing younger members into the insurance program. Once in the program, members would be likely to continue participation (even when premium rates became less competitive) because of inertia or because they might be precluded from obtaining other insurance. Second, the ability and willingness to make charitable contributions was expected to increase with a member's age and concomitant rise in income. Older members were therefore more likely to stay in the program even though an increasing portion of their dividends was devoted to charity rather than the purchase of insurance.

the insurance companies to compute net premiums on the basis of the most favorable risk ratings. Because the method for determining such ratings is important to various aspects of the case, it warrants discussion.

Insurance premiums for individual (nongroup) insurance are based on a person's life expectancy (mortality) for life insurance and expectancy of illness (morbidity) for health and disability insurance. These expectancies are derived from statistical tables that provide accurate information for the entire population but can only serve as approximations for any one individual. Characteristics such as present health, tobacco use or occupation have a significant bearing on the likelihood that a person will die or become disabled. Insurance companies therefore attempt to discover these factors in order to make an appropriate premium adjustment or to deny coverage altogether.

Screening these risk factors can be time consuming and costly, and may require detailed questionnaires and medical examinations. The more exacting the process, the more likely that the premium charged will reflect the risk incurred. However, as the screening process becomes more difficult, it also becomes more expensive for the company and more discouraging to applicants. Insurance companies therefore try to identify applicants with better than average life or health expectancy through methods that minimize or eliminate individual screening.

One such method is to identify groups whose members have more favorable mortality or morbidity statistics than the general population. Professional associations are prime examples of such groups. Members of professional associations are generally better educated than the population as a whole and more likely to be well nourished and have access to

first-rate medical care. Professional associations also generally consist of members of a single profession, excluding individuals with more hazardous occupations.

While mortality and morbidity tables geared to a particular profession provide a better approximation of risks than tables geared to the population at large, the experience of a particular group within a profession may differ from the experience of the profession as a whole. Under certain circumstances, it is possible for an insurance company to arrive at a still more precise measurement of risks by providing insurance based on the experience of the group itself. This can only be done with a group that is large enough to provide a statistically meaningful experience that is not likely to fluctuate greatly from year to year. When an insurance company sets rates for a group on the basis of that group's own experience, that insurance plan is deemed to be experience rated. By further lowering costs, experience rating provides significant advantages in calculating dividends for participating insurance plans.

An important cost advantage secured by the Endowment was to assure that the ABE insurance plans were experience rated. Because the mortality and morbidity experience for the group was more favorable than for the legal profession as a whole, the net cost of ABE insurance was lower than the net cost of insurance available through other bar associations. The Endowment was also able to secure additional advantages. For example, while it collected premiums from members semi-annually, it transmitted them to the insurance companies only once a year, gaining the benefit of the float on a portion of the premiums. As to one of the plans, it was able to avoid charges for a

certain type of reserve by establishing an escrow account with its own securities to absorb the risk. In general, the Endowment leadership used the size and prestige of the ABE account to vigorously negotiate the most advantageous possible cost structure for each of the insurance plans.

This strategy of cutting costs and keeping gross premiums high has been fabulously successful. Over the 28 years that the insurance program has been in effect, the Endowment has netted an astounding $81.9 million in dividends, $63 million of which it has devoted to its charitable endeavors. It should be noted that not all Endowment insurance programs have been equally successful in raising revenues in every year. However, on an overall basis, the Endowment's strategy was successful and it is clear that any plan not expected to generate large dividends in the long run would have been discontinued regardless of its popularity.

2. *Individual participation*

Individual ABE members were well informed about the fundraising nature of the insurance program. Advertising and promotional materials clearly indicated that objective. As a condition for participating in any of the plans, members agreed to assign all premium refunds to the Endowment. Applications for insurance contained such an assignment immediately above the signature line.

Dividends were calculated by the insurance companies separately for each of the Endowment's five insurance plans. At the end of each year, the underwriter for each plan refunded to the Endowment that portion of the gross premiums exceeding the cost of servicing that plan. The Endowment kept the money

and informed members participating in each plan what percentage of the total premiums had been refunded and used for charitable purposes. Many members then multiplied the stated percentage by the amount they had paid in premiums under that plan and deducted that amount from their income taxes as a charitable contribution. Each of the individual plaintiffs did so with respect to one or more of the insurance plans in one or more of the years in issue.

Discussion

The court must determine whether the Endowment's activities amounted to a trade or business subject to the UBIT and whether the individual members are entitled to deduct a portion of their premiums as charitable contributions. Although these questions have some elements in common, they present separate issues and require separate legal analyses.

A. *THE ENDOWMENT*

1. The Unrelated Business Income Tax, as its name suggests, is levied on the "unrelated business income" of certain tax-exempt organizations. 26 U.S.C. § 511(a)(1) (1976). Unrelated business taxable income is defined as "the gross income derived by any organization from any unrelated trade or business." *Id.* § 512(a). "Trade or business" in turn is defined as "any activity which is carried on for the production of income *from the sale of goods or the performance of services.*" *Id.* § 513(c) (emphasis added).

When considering a tax-exempt organization that is a charity, the court must distinguish between those activities that constitute a trade or business and those that are merely fundraising. Over the years, chari-

ties have adopted fundraising schemes that are increasingly complex and sophisticated, relying on many business techniques. *See, e.g.*, Wingis, *Fund Raiser Profits From New Techniques*, Advertising Age, Jan. 17, 1983, at M-42; Shapiro, *Marketing for Nonprofit Organizations*, Harv. Bus. Rev., Sept.-Oct. 1973, at 123. Charitable activities are sometimes so similar to commercial transactions that it becomes very difficult to determine whether the organization is raising money "from the sale of goods or the performance of services" or whether the goods or services are provided merely as an incident to a fundraising activity.

Fortunately, the Court of Claims provided significant guidance on this issue in its well-reasoned opinion in *Disabled American Veterans* v. *United States*, 227 Ct. Cl. 474 (1981). That case involved a charitable organization that engaged in a variety of activities each of which provided revenues to the organization. The court held that some of the activities constituted a trade or business, and therefore produced income subject to the UBIT, while others were fundraising activities and not taxable. The test enunciated by the court in *Disabled American Veterans* is whether the activity in question is "operated in a competitive, commercial manner." *Id.* at 489. Operations not conducted in such a manner were deemed to be fundraising activities not subject to the UBIT.

Whether an activity is operated in a competitive, commercial manner is a question of fact and turns upon the circumstances of each case. At bottom, the inquiry is whether the actions of the participants conform with normal assumptions about how people behave in a commercial context. If they do not, it may be because the participants are engaged in a charitable fundraising activity. *Disabled American Vet-*

erans illustrates this point. Among the activities considered in that case was the sale of certain items such as books, maps, charts and wrist calendars. 227 Ct. Cl. at 482-83. The court found that some of those items were sold by the charitable organization at prices close to their market value. As to those items, the activity was held to be a trade or business because the motivation of the buyers could be explained entirely in terms of a commercial transaction. Certain other items were sold at prices far in excess of their market value. As to those items, the court found that the sales activity was not a trade or business because the actions of the buyers could not be explained by reference to commercial motivations but only by an intent to participate in a charitable fundraising activity.

2. In determining whether the ABE insurance program was operated in a commercial manner it is appropriate to start with the observation that the program was devised as a means for fundraising and has been so presented and perceived from its inception. When the program was first developed in the mid-1950's, professional association group insurance was virtually unheard of. The idea of offering coverage through voluntary group participation was a pioneering idea in the insurance industry, so much so that the Endowment had some difficulty finding an underwriter for the program. The availability of group insurance of various types has proliferated over the intervening three decades; in many instances group insurance plans have been operated and promoted for commercial purposes. It is significant, however, that the ABE did not develop its fundraising plan by copying or adapting commercial ventures but vice versa.

Despite the widespread commercialization of group insurance plans, the Endowment has stubbornly adhered to the original concept that its plans are exclusively for fundraising. Advertising and other promotional materials consistently referred to the use of dividends for the Endowment's charitable endeavors; the Endowment's annual reports discussed the insurance program as a source of charitable contributions; communications to policyholders consistently referred to the Endowment's retention of dividends as donations, not as profits. In short, both the ABE leadership and the insured members considered the insurance program a fundraising activity and treated it as such.[5]

It is, of course, inappropriate to give the perceptions and labels of the parties conclusive effect. However, it is also wrong to ignore these facts altogether. *Disabled American Veterans* requires a determination as to the motivation of the participants in the transaction. The manner in which the program was presented and perceived can be an important factor in that determination. This is particularly so where, as here, the transaction is relatively unusual, defying ready classification, and the perception of the program as a fundraising activity has been held by many thousands of people for the better part of three decades.

Another significant factor is the staggering amount of money consistently generated by the Endowment's

[5] Even those ABE members who testified for the defendant appeared to share this view. While these witnesses disagreed with the manner in which the program was operated and would have preferred to pay lower premiums by terminating the program's fundraising function, they certainly never suggested that the Endowment was operating a business which was profiting at their expense.

activities. In 1979, the Endowment collected $12.8 million in gross premiums and received about $5.1 million in dividends. Its expenses were less than $1.5 million. If this were a business, as defendant suggests, its profit margin would have been 240%. For 1980 and 1981 profit margins would have been over 400% and 260%. These margins were typical; over the years the Endowment has netted approximately 300% over expenses.

The evidence presented and common sense suggest that such profit margins cannot be maintained year after year in a competitive market. With one exception, no business involved in the underwriting, sale, brokering or administration of insurance has been able to earn profits even approaching this level. The exception involved sales of insurance to a captive market, a practice considered abusive and promptly subjected to regulation in many states.[6] Certainly no legitimate business has been able to match the astounding profitability of ABE's program, and no business (legitimate or otherwise) has been able to maintain that level of profit for any sustained period.

Yet another significant factor is the Endowment's candor toward its members and the public concerning the operation of the insurance programs and the revenues derived therefrom. ABE went to great lengths to publicize all relevant facts in annual reports, direct communications with insured members, promotional materials and other ways. As is typical of charitable fundraising campaigns, the ABE took great pride in letting the world know how much

[6] An example of this practice were lenders who sold credit insurance to people applying for loans. The granting of the loan was conditioned on the purchase of insurance. This put significant pressure on the borrower, enabling the lender to charge exorbitant rates for the insurance.

money was collected each year and the uses to which the money was put. This openness creates yet another contrast with normal perceptions of a business. Generally, business enterprises strive to keep their profit margins secret, particularly where those margins are inordinately high.

The final and most telling factor is that the insurance program was operated with the approval and consent of the ABA membership. The ABA consists of some 300,000 members who have the good fortune of belonging to a group with a very favorable mortality and morbidity rating. This is a valuable asset. Most professional associations (including almost all bar associations) operate such programs on a service-oriented basis and secure the most economical group insurance for their members. If the ABA had chosen to do this, it could have offered its members insurance at premiums lower than any other bar association, perhaps the lowest premiums of any group in the country. The ABA members, however, have chosen a more generous approach, allowing the Endowment (rather than the ABA) to operate the insurance program and retain the dividends. This approach is costly to the members who buy the insurance because they are required to pay much more than if the ABA were operating the program as a service. The program is also very costly to those members who do not participate in the ABE insurance plans because they are foreclosed from considering the cheaper insurance that would otherwise be available.[7] Yet, over the years there has been surprisingly little dissent. While a handful of members have voiced a preference for lower-priced insurance, there has never been any organized effort to change the existing policy.

[7] The money that could have been saved by the members who bought insurance was equal to the dividends refunded minus the Endowment's operating expenses. This amounted to several million dollars a year. *See* p. 5 *supra*. Only about one-sixth of the members bought any insurance, however, and few of those took advantage of all the programs available. The cost to the nonparticipating members, many of whom had to buy more expensive insurance elsewhere, is not so easily quantifiable but could be many times greater than the losses suffered by the insured members.

Defendant suggests that ABA/ABE members have no control over the way the insurance programs are operated because the programs are maintained in their present form by an unresponsive leadership. The court finds to the contrary. In the first place, there is nothing to suggest that the ABA/ABE leadership is unresponsive to the wishes of the members they represent. While support for the current method of operating the programs is strong among ABA/ABE officials, this appears to be in great part a reflection of the membership's view. If the ABA/ABE leadership determined that a majority of the members wanted a change, there is every reason to believe that the leadership would take appropriate steps to implement it.[8] Moreover, even if one were to assume that the ABA/ABE leadership is unresponsive, it is not at all clear that it could stifle a grassroots movement to change the method of operating the insurance programs. Plaintiff has demonstrated to the court's satisfaction that there are ample, effective channels

[8] If the insurance programs were to be operated in a service-oriented fashion, it might be necessary to withdraw them from the ABE and have the ABA operate them directly. *See* Treas. Reg. § 1.501(c)(3)-1(c)(1) (1959).

within the ABA for members to make their views known and have them implemented.[9]

When taken together, these factors make it impossible to conclude that the insurance programs were operated by ABE in a competitive, commercial manner. The Endowment raised huge sums of money by its activities, sums wholly unrelated to the value of any service it provided and which dwarfed the profit margins of insurance-related businesses. It disclosed the relevant facts to its members at every available opportunity, yet the members (who bore the economic cost of this program) allowed the practice to continue although they collectively had the power to change it. No business could operate in this fashion. Supermarkets would go broke if shoppers could approve prices; airlines would never leave the ground if passengers could decide what the fares should be; automobile rental companies would be driven out of business if customers could set the rates. By the same token, neither consumers nor the competitive marketplace long tolerate business enterprises that make huge profits without delivering commensurate value in return. *See, e.g.*, p. 8 & n.6 *supra*. One would

[9] For an instructive illustration of how an attorney organization can override a decision made by its leadership see, *D.C. Bar Petitions Court to Increase Dues Ceiling*, B. Rep., Mar. 1980, at 1-12; *The Referenda are Coming*, B. Rep., Oct.-Nov. 1980, at 1-9; and *Referendum Results Tabulated; Board of Governors Submits Material to D.C. Court of Appeals*, District Lawyer; Jan.-Feb. 1981, at 20, 50-60. These articles chronicle the successful efforts of the D.C. Bar's rank and file to limit dues increases proposed by tne leadership and to restrict the bar's functions in contravention of the leadership's wishes. Defendant has suggested no reason why the ABA members could not equally well overcome any intransigence on the part of the ABA leadership.

have to assume that ABA/ABE members have been subject to an epidemic of irrationality in permitting themselves to be bilked in this manner for almost three decades. The far more reasonable explanation is that the members are entirely rational and are permitting the ABE to collect such substantial revenues at their expense because they consider the Endowment to be engaged in fundraising, which they support. By any standard, an enterprise that depends on the consent of its customers for its profits is not operating in a commercial manner and is not a trade or business.

This conclusion is supported by the language of the statute. The amount of money ABE is permitted to retain far exceeds the value of any service it may be providing through the operation of the insurance programs. It is quite obvious, then, that this money was not earned "from the sale of goods or the performance of services," 26 U.S.C. § 513(c) (1976), but for some other reason. That reason was the intent of the members to support the Endowment's charitable activities.

3. Defendant argues that the Endowment's activities must be deemed a business under *Disabled American Veterans* because the rates it set for insurance were within the competitive range in the market. Defendant reads *Disabled American Veterans* far too narrowly.[10]

[10] The record does not, in any case, fully support defendant's factual contention. As will be discussed more fully below, *see* pp. 16-17 *infra*, it is impossible to isolate a single market for insurance. The cost of insurance depends on a variety of factors, many of them individual to each buyer. Thus, while ABE insurance may have been within the competitive range for some potential buyers it was not for others.

Nothing in *Disabled American Veterans* suggests that price disparity is the only factor the court may consider in differentiating a fundraising activity from a business. The broad teaching of *Disabled American Veterans* is that the court should compare the operation of the activity in question with normal business practices to determine whether the enterprise is being run in a commercial fashion. If an aspect of the operation appears inconsistent with normal business practices and the difference can only be explained by an intent to benefit a charity, the enterprise may well be a fundraising activity and not a business. Here, the fundraising activity is operated so differently from that in *Disabled American Veterans* that the comparison of the rates charged with others available in the market proves not to be a decisive factor. The premise of a business transaction is negated by the fact that ABA/ABE members as a group have permitted the Endowment to collect exorbitant revenues when they could easily deny it *any* income if they so desired.

Equally unavailing is defendant's argument that the Endowment's professional marketing and efficient administration of the insurance programs renders the activity a trade or business. Defendant's own expert economist testified that good organization and effective advertising does not distinguish a charitable enterprise from a commercial one. Fundraising, like any other activity, depends upon sound organization for success. *See generally* Shapiro, *Marketing for Nonprofit Organizations*, Harv. Bus. Rev., Sept.-Oct. 1973, at 123. Promotion in particular has become a recognized and important aspect of modern fundraising. Once the ABA/ABE members allow the Endowment to raise funds through the operation of the insurance program, the organization must do whatever is necessary to maximize the revenues derived therefrom: The Endowment's leadership would be remiss if it did less. It would be entirely inappropriate for ABA members to give up the opportunity to obtain the lowest group rates and then have the benefits of their generosity squandered because the Endowment did not do what was required to maximize the amount raised for charitable purposes.

4. Defendant cites a number of recent decisions holding that operation or sponsorship of insurance programs by tax-exempt organizations constitutes a trade or business. *See Carolinas Farm & Power Equipment Dealers Association* v. *United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League* v. *United States*, 693 F.2d 525 (5th Cir. 1982); *Professional Insurance Agents* v. *Commissioner*, 78 T.C. 246 (1982). *See also Long Island Gasoline Retailers Association* v. *Commissioner*, 43 T.C.M. (CCH) 815 (1982) (issue conceded by petitioner). These cases are not on point.

The organizations sponsoring the insurance programs in each of those cases were business leagues exempt from taxation under section 501(c)(6); ABE is a charitable organization exempt under section 501(c)(3). Business leagues are not charities as that term is generally understood; they are operated to promote the parochial interests of their members, not those of the public at large. Such organizations provide a variety of services to their members, generally financed through dues or other direct contributions. Payments to such organizations have a business purpose and are not charitable in nature. Congress has

recognized this by providing that payments to 501 (c)(6) organizations may not be deducted from gross income as charitable contributions, while those to 501 (c)(3) organizations may. 26 U.S.C.A. § 170(c) (West 1978 & Supp. 1983). At the same time, dues payable to 501(c)(6) organizations are generally deductible as business expenses. *See Smith-Bridgman & Co.* v. *Commissioner*, 16 T.C. 287, 295 (1951).

When dealing with trade associations or business leagues, therefore, the analysis of *Disabled American Veterans* is simply inapposite. Once it is shown that a 501(c)(6) organization is engaging in an income-producing enterprise, the activity must perforce be deemed a business because such organizations do not engage in charitable fundraising. By contrast, fundraising is an important and frequently continuous process for charitable organizations. *Disabled American Veterans* recognized, however, that there is sometimes a very thin line between fundraising and business activity. The court must therefore engage in a sensitive analysis of the relevant factors to determine the precise nature of the venture. Such weighing only becomes relevant if the organization is one for which fundraising is a possibility; the analysis of *Disabled American Veterans* has no bearing to the issues presented in *Carolinas Farm, Louisiana Credit Union League* and *Professional Insurance Agents.*

The cases cited by defendant are also distinguishable factually. In each case the organization was paid a fixed percentage of the premiums collected, ranging from 2½ to 8%. These percentages, which are well within the range normally paid for those types of promotional and administrative services, stand in stark contrast to the 40, 50 and even 90% of premiums regularly refunded as dividends and

retained by ABE. Moreover, none of the cited cases suggest that members were fully informed of the arrangement with the insurance company and permitted it to continue even though it caused them a monetary loss. In at least one case the court found to the contrary. *Professional Insurance Agents*, 78 T.C. at 251-52. In short, each of the cases cited discloses a situation where the insurance plans and related activities were conducted precisely as one would expect a business to operate.[11] Therefore, even if the test enunciated in *Disabled American Veterans* were applicable to 501(c)(6) organizations—which the court believes it is not—there would be no inconsistency between the results reached here and those reached in the cases cited by defendant.

5. Because this case presents an unusual fact situation, not squarely controlled by either the language of the statute or by case precedent, it is appropriate to consider the legislative history of the UBIT to determine whether the arrangements here run afoul of the congressional purposes in imposing the tax. Since the Court of Claims analyzed the legislative history of the UBIT in *Disabled American Veterans*, 227 Ct. Cl. at 478-79, there is no reason for doing so again. It is sufficient to note that, based upon its examination, the court found as follows:

> The legislative history of sections 511-13 demonstrates that Congress perceived the tax-free operation of an unrelated trade or business by an

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[11] The court in *Carolinas Farm* specifically so found, reserving the question of whether it would have reached a different result if the organization had not been operating in a commercial manner. 699 F.2d at 170 n.5.

> exempt organization to provide an unfair advantage over competitors. The primary purpose for subjecting unrelated business income to taxation was to remove this unfair competitive edge.

Id. at 479 (footnote omitted). The court must therefore determine whether the ABE's activities have an anticompetitive effect or otherwise place tax-paying enterprises at an unfair disadvantage.

In attempting this analysis one encounters the problem of determining in what market ABE was operating and who its potential competitors were. This differs from many cases involving the UBIT where effects upon competition can be readily ascertained. *See, e.g., Carle Foundation* v. *United States*, 611 F.2d 1192 (7th Cir.), *cert. denied*, 449 U.S. 824 (1980) (sale of pharmaceuticals); *Cooper Tire & Rubber Co. Employees' Retirement Fund* v. *United States*, 306 F.2d 20 (6th Cir. 1962) (leasing of tire manufacturing equipment); *American College of Physicians* v. *United States*, 3 Cl. Ct. 531, *appeal docketed*, No. 84-715 (Fed. Cir. Dec. 20, 1983) (publication of advertising); Rev. Rul. 79-361, 1979-2 C.B. 237 (operation of miniature golf course); Rev. Rul. 55-449, 1955-2 C.B. 599 (construction and sale of houses). It is also not without significance that for 21 years the Internal Revenue Service took the position that ABE's operation of the insurance program was not taxable. *See* I.R.S. Letter Ruling 8042012 (July 3, 1980) (citing unpublished technical advice memorandum of January 31, 1973 that concluded ABE's insurance program was not a business). This suggests that whatever UBIT policies the ABE's activities are thought to implicate must be subtle indeed.

The Endowment was not in the business of underwriting insurance; this function was performed by two large insurance companies, New York Life and Mutual of Omaha. Moreover, when viewed from the perspective of insurance carriers, the ABE's activities were procompetitive. As previously noted, there was a constant tension between the Endowment, which wanted to set premiums high to maximize dividends, and the underwriters, which wanted to keep the premiums low to attract more members into the program. By keeping premiums high, the Endowment diminished the amount of business flowing to the two underwriters from ABE members, presumably dispersing that business to other insurance companies. Had the program been operated entirely as a service, offering the lowest possible rates, many more members would have joined the program and there would have been greater concentration of business in the two insurance carriers.

The Endowment does, of course, act as an intermediary between its members and the insurance companies. Yet, given the characteristics of group insurance, there can be just one such intermediary. The only way in which ABA members could take advantage of the benefits of group membership (either for themselves or for charitable purposes) was to have an intermediary negotiate the best possible deal for the group as a whole. ABE performed that function and there could be no second such intermediary acting for the group as a whole. To be sure, there were others competing for the opportunity to act as intermediaries for individual members of the ABE. These intermediaries would not, however, be in direct competition with the ABE for the business of the group as a whole. In any case, ABE's

insistence on large dividends, which generated the income the government now wants to tax, increased the competitive advantage of these other intermediaries. Over 80% of ABE members bought no insurance through the Endowment, most of them presumably obtaining insurance through other intermediaries. A change in ABA's policy that would make the insurance available to members at the lowest possible group rates would drain much business from these other intermediaries.

The absence of any identifiable business over which the ABE is able to gain an unfair advantage supports the conclusion that its activities are not commercial and therefore not a business. At the very least, it suggests that nothing in the policies underlying the UBIT requires that the Endowment's activities be taxed. Indeed, it appears that the Endowment's activities have an entirely procompetitive effect, fully consistent with the policies of the UBIT. The congressional purpose behind the statute would therefore not be served by holding that the Endowment was engaging in a business activity by operating the insurance program.

B. *THE INDIVIDUAL PLAINTIFFS*

The plaintiffs in Nos. 163-83T, 190-83T, 320-83T and 351-83T are ABE members and their wives. Each member has participated in one or more of the ABE insurance plans and has taken a charitable deduction for dividends refunded on his behalf by the insurance companies but retained by the Endowment. Plaintiffs claim a deduction on the theory that each payment to ABE constituted a dual payment: part for insurance and part as a contribution to the Endowment's charitable endeavors. They claim that the

portion representing a charitable contribution is properly measured by the amount of the premium refunded as a dividend and retained by ABE. Defendant argues that the payments made by plaintiffs were entirely for insurance and that plaintiffs are therefore not entitled to a charitable contribution deduction for any portion of the payments.

1. *The Legal Standard*

It is well established that a payment can consist of two components, one that is commercial in nature and another that is a charitable donation. *See Singer Co.* v. *United States*, 196 Ct. Cl. 90, 109 (1971); *Oppewal* v. *Commissioner*, 468 F.2d 1000, 1002 (1st Cir. 1972); *Arceneaux* v. *Commissioner*, 36 T.C.M. (CCH) 1461, 1464 (1977); *Murphy* v. *Commissioner*, 54 T.C. 249, 253 (1970); Rev. Rul. 68-432, 1968-2 C.B. 104. To establish a dual payment, the taxpayer must demonstrate that he bought goods or services for more than their economic value, with the intention that the excess be used to benefit a charitable enterprise. Rev. Rul. 67-246, 1967-2 C.B. 104, 105. A corollary to this rule is that there can be no dual payment where the entire amount paid by the taxpayer is economically motivated, that is, where the payment is made to obtain goods or services for which the taxpayer would be willing to pay the full price even absent the charitable contribution. *See, e.g., Arceneaux*, 36 T.C.M. (CCH) at 1464 (payment by adoptive parents to adoption agency not a contribution); *Werbianskyj* v. *Commissioner*, 34 T.C.M. (CCH) 467, 468 (1975) (payment for girl scout cookies not a contribution absent showing that price exceeded product's fair market value).

Normally, a determination of whether the payment for a good or service exceeds what the buyer would have been willing to pay in a purely commercial transaction is made by reference to the commodity's market value. Market value can be determined by various techniques, a preferred one being to compare market transactions for similar goods or services. *See, e.g.*, Rev. Rul. 80-233, 1980-2 C.B. 69. The valuation of insurance is more difficult. Unlike other types of goods or services that have more or less the same value regardless of who is the buyer, the cost of insurance varies drastically with the identity of the insured. Thus, for example, $100,000 of life insurance will (all other things being equal) be much less expensive for a healthy, 30-year old, nonsmoker of normal weight than for a 50-year old cigarette smoker who is obese and has a history of heart disease.

The value of insurance also turns on factors that are not specific to individual buyers. One important factor is whether the insurance policy is an individual one or part of a group plan. Group insurance frequently is limited as to the type and maximum amount of coverage available. The subscriber must also remain a member of the group to continue participation in the group policy. The terms of a group plan may be altered by the group without the consent of the individual insured. On the other hand, group plans frequently offer attractive rates. Group plans also generally provide some level of insurance without proof of insurability and additional levels of insurance with only a limited inquiry and without a physical examination.

Group plans offer attractive premiums for many people but they do not offer the lowest premiums for all members of the group. Because individual

insurance coverage can be geared to a person's health status and other individual characteristics, people qualifying for preferred risk rates may be able to obtain individual insurance that is less expensive than group insurance. Individual insurance also provides the option of buying virtually unlimited coverage and tailoring a policy with such frills as waiver of premium, double indemnity and insuring one's insurability. The benefits under an individual policy cannot be changed except pursuant to its terms or with the consent of the insured. In addition, individual policies are available not only as term insurance but also, in the case of life insurance, as whole life. Many insurance buyers find the forced-savings and safe-investment features of whole life insurance attractive. Group life insurance plans offer only term insurance.[12]

Another important factor to consider in valuing life insurance is the identity of the carrier. Some insurance companies are more reputable than others; some pay claims liberally while others are more conservative. Such differences influence buyers of insurance in the selection of their coverage. Geography also has an effect upon the price of insurance. For reasons that are not entirely clear, there is no national market for insurance; the availability and cost

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[12] While it is difficult to generalize, it is fair to say that group insurance is likely to be most attractive to people who prefer relatively small amounts of coverage, those who are subject to some risk which precludes them from obtaining individual insurance at preferred rates and those who prefer not to deal directly with insurance agents or be bothered with intrusive health questionnaires or medical examinations. All things being equal, however, a person eligible for both individual insurance and group insurance at the same price is likely to select the individual insurance because of the additional security and flexibility afforded by individual policies.

of insurance can vary significantly depending upon the place where the insured resides.

To establish that a portion of the payment for ABE insurance is a charitable contribution, a plaintiff must show that an equivalent insurance product was available to him for a lower price [13] and that he by-passed that product because he wished to make a charitable contribution to the Endowment. A plaintiff's mere awareness that a portion of his payment would be devoted to charitable purposes is not sufficient to establish that he made a charitable contribution. Only if the plaintiff passed up an economically more attractive package in order to participate in the Endowment's insurance program can the court find that there has been a dual payment.

Plaintiffs argue that such a painstaking inquiry for each insured member is inappropriate because the value of the insurance provided through the ABE was the net cost charged by the underwriter (the gross premium minus the dividend). They base this argument on the fact that ABE members can change the arrangement at any time, thereby depriving the Endowment of the dividends. *See* p. 10 *supra*. In plaintiffs' view, then, each member is entitled to deduct the dividend attributable to him because he has participated in the group decision permitting the Endowment to retain dividends and such participation establishes charitable intent. The court cannot accept this view. Whether the Endowment operates the insurance program as a service, as a business or as a fundraising activity is a group decision, deter-

[13] Seldom are two insurance plans identical. Any differences between the alternative insurance and that available through the Endowment would have to be factored into the valuation process.

mined by group processes; once made it is binding on all members, even those who disagree with it. The decision whether to buy insurance and/or whether to make a charitable contribution is an individual one. That the group as a whole could lower insurance rates is of little relevance to an individual member who must decide whether or not to participate in the insurance program as it is in fact structured.[14] For some ABE members the insurance offered through the Endowment is not a very good deal; they may choose to buy it anyway because they wish to contribute to the Endowment's activities. Other members might find the insurance to be a good value; they would buy the insurance regardless of whether they intended to make a donation. Under the applicable law, these two groups must be treated differently. An individual inquiry must be conducted as to each member to determine to which group he belongs.

Plaintiffs point to the obvious mechanical difficulties in making these determinations on a case by case basis for the 55,000 or so ABE members who participate in one or more of the insurance plans every year. They urge the advantages of a unified approach such as that adopted by Congress in 26 U.S.C.A. § 79 (West 1967 & Supp. 1983). Section 79(c) establishes uniform rates for employer funded group term life insurance. *See* Table I of Treas. Reg. § 1.79-3(d)(2) (1983). The simplified approach of section 79 deals with a specific problem Congress recognized and chose to address. While, here too,

[14] Any consent to ABE's retention of the dividends that can be inferred from the fact that a member refrains from agitating for a change in ABA policies is simply too remote to establish a charitable intent.

there might be much wisdom in avoiding individual adjudication of thousands of claims as to the value of insurance, it is up to Congress, or perhaps the Commissioner pursuant to his regulatory authority, to provide such a solution. This court can only decide the cases before it and must defer to those with broader authority to address problems of broader scope.

2. *Application to These Cases*

No. 351-83T. Plaintiff Herbert C. Broadfoot, II, carried ABE life insurance in the amount of $50,000. He testified that he was aware that a portion of his premium payment would go to the Endowment to support its charitable purposes. As indicated above, such knowledge is not sufficient to establish charitable intent. Nothing on the record suggests that similar insurance was available to plaintiff at a lower price and that he bypassed that opportunity in order to make a contribution to the Endowment. On the contrary, plaintiff testified that premiums for insurance offered by his state bar association were higher than for comparable ABE coverage. Since plaintiff failed to carry his burden, the court finds for the defendant.

No. 320-83T. Plaintiff Frederick G. Boynton participated in ABE's disability insurance program and was also aware that part of his premium would be used by the Endowment to support its charitable activities. The record discloses no information as to other available insurance and therefore does not support a finding that Mr. Boynton purchased ABE insurance for reasons other than his own economic interest. The court finds for defendant.[15]

[15] This plaintiff also presented an unrelated claim based on a $50 business deduction for his membership in Eastern Air-

No. 163-83T. Plaintiff Frederick D. Turner is enrolled in ABE's group life insurance program. Like the others, he indicated that he was aware of the charitable uses to which part of his payment would be put. Here again, however, plaintiff has failed to make the necessary showing and the court finds for defendant.

No. 190-83T. Plaintiff Arthur M. Sherwood presents the most interesting and difficult case. Mr. Sherwood participated in the ABE's life insurance program by buying insurance in the amount of $20,000.[16] He was also eligible to participate in the plan offered by the New York State Bar Association. For the three years here in issue, the insurance offered under that plan would have been cheaper for Mr. Sherwood. Moreover, the insurance offered under the New York State Bar Association plan was underwritten by the same insurance carrier as the ABE plan, making the two plans comparable.[17]

While this plaintiff, unlike the others, has established that a comparable product was available to him at a lower price, he did not state that he was aware of the existence of this product during the years in issue and decided to purchase ABE insur-

lines' Ionosphere Club which provides lounges and other facilities at various airports. Plaintiff testified that he used these facilities to work while awaiting flights. After plaintiff testified, defendant conceded his entitlement to the deduction.

[16] Mr. Sherwood also purchased dependent coverage through the ABE. Because the record is devoid of evidence on comparable rates for such insurance, the court finds for defendant on this point.

[17] While the two plans were not identical, the differences were sufficiently minor that they could be ignored or eliminated through mathematical adjustments.

ance instead because he wanted to make a charitable contribution. The court therefore finds for the defendant.

Conclusion

ABE's insurance program is not a trade or business taxable under the UBIT. None of the individual plaintiffs are eligible for a charitable contribution deduction on account of payments made to ABE for the purchase of insurance. Plaintiff in No. 320-83T is entitled to a business deduction of his payment to the Ionosphere Club.

No later than 12:30 p.m. on Thursday, February 2, 1984, the parties shall file a stipulation setting forth the amount of plaintiffs' judgment in Nos. 465-82T and 320-83T. Upon receipt of this stipulation, the clerk is directed to enter judgment in favor of plaintiffs in these two cases in the amounts stipulated and to dismiss the complaints in the other cases. If the parties are unable to file a stipulation, a status hearing will be held at 2:00 p.m. EST on February 2, 1984, in Courtroom No. 4, Fifth Floor, National Courts Building, 717 Madison Place, N.W., Washington, D.C. 20005.

The prevailing party in each case shall recover its costs. 28 U.S.C. § 2412(a) (Supp. V 1981); RUSCC 54(d). The plaintiff is the prevailing party in No. 465-82T and defendant is the prevailing party in Nos. 163-83T, 190-83T, 320-83T and 351-83T.

APPENDIX D

IN THE UNITED STATES CLAIMS COURT

Nos. 465-82T, 163-83T, 190-83T,
320-83T, 351-83T

AMERICAN BAR ENDOWMENT, ET AL.

v.

THE UNITED STATES

[Filed Feb. 2, 1984]

JUDGMENT

Pursuant to the opinion of January 31, 1984, and the stipulation re judgment amounts filed by the parties on February 2, 1984, it was held that plaintiffs in Case Nos. 465-82T and 320-83T are entitled to recover, with the complaints in 163-83T, 190-83T and 351-83T to be dismissed.

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that plaintiff in Case No. 465-82T, American Bar Endowment, recover of and from the United States the following amounts of unrelated business income tax and assessed interest previously collected plus statutory interest as provided by law, with costs to said plaintiff:

	Fiscal Year 1979	Fiscal Year 1980	Fiscal Year 1981
Tax	$1,587,924.00	$2,326,774.00	$2,105,709.00
Assessed Interest	427,845.15	376,363.66	87,459.04

that plaintiff in Case No. 320-83T, Frederick G. Boynton, recover of and from the United States the sum of $19.00 in income tax plus statutory interest as provided by law, with costs to the defendant.

IT IS FURTHER ORDERED AND ADJUDGED this date, that the complaints in Case Nos. 163-83T, 190-83T and 351-83T are dismissed, with costs to the defendant.

FRANK T. PEARTREE

Clerk of Court

By: /s/ Debra L. Samler
Deputy Clerk

NOTE: As to appeal, 60 days from this date, see FRAP 4(a).

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.), as amended and as in effect for the years at issue:

SEC. 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

(a) *Exemption From Taxation.*—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

(b) *Tax on Unrelated Business Income and Certain Other Activities.*—An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in parts II, III, and VI of this subchapter, but (notwithstanding parts II, III, and VI of this subchapter) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

(c) *List of Exempt Organizations.*—The following organizations are referred to in subsection (a):

(1) Corporations organized under Act of Congress, if such corporations are instrumentalities of the United States and if, under such Act, as amended and supplemented, such corporations are exempt from Federal income taxes.

(2) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less ex-

penses, to an organization which itself is exempt under this section.

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

(4) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

(5) Labor, agricultural, or horticultural organizations.

(6) Business leagues, chambers of commerce, real-estate boards, boards of trade,

or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(7) Clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.

(8) Fraternal beneficiary societies, orders, or associations—

(A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and

(B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

(9) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

(10) Domestic fraternal societies, orders, or associations, operating under the lodge system—

(A) the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and

(B) which do not provide for the payment of life, sick, accident, or other benefits.

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SEC. 502. FEEDER ORGANIZATIONS.

(a) *General Rule.*—An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501.

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SEC. 511. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS.

(a) *Charitable, Etc., Organizations Taxable at Corporation Rates.*—

(1) *Imposition of tax.*—There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a normal tax and a surtax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income."

(2) *Organizations subject to tax.*—

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(A) *Organizations described in sections 401(a) and 501(c).*—The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)(1)) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

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SEC. 512. UNRELATED BUSINESS TAXABLE INCOME.

(a) *Definition.*—For purposes of this title—

(1) *General rule.*—Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

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(3) *Special rules applicable to organizations described in section 501(c)(7) or (9)—*

(A) In the case of an organization described in section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). For purposes of the preceding sentence, the deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall be treated as not directly connected with the production of gross income.

(B) *Exempt Function Income.*—For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside—

(i) for a purpose specified in section 170(c)(4), or

(ii) in the case of an organization described in section 501(c)(9), to provide for the payment of life, sick, accident, or other benefits, including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii). If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

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(4) *Special rule applicable to organizations described in section 501(c)(19).*—In the case of an organization described in section 501(c)(19), the term "unrelated business taxable income" does not include any amount attributable to payments for life, sick, accident, or health insurance with respect to members of such organizations or their dependents which is set aside for the purpose of providing for the payment of insurance benefits or for a purpose specified in section 170(c)(4). If an amount set aside under the preceding sentence is used during the taxable year for a purpose other

than a purpose described in the preceding sentence, such amount shall be included, under paragraph (1), in unrelated business taxable income for the taxable year.

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SEC. 513. UNRELATED TRADE OR BUSINESS.

(a) *General Rule.*—The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function construing the basis for its exemption under section 501 (or, in the case of an organization described in section 511 (a)(2)(B), to the exercise or performance of any purpose or function described in section 501 (c)(3)), except that such term does not include any trade or business—

(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) which is carried on, in the case of an organization described in section 501(c)(3) or in the case of a college or university described in section 511(a)(2)(B), by the organization primarily for the convenience of its members, students, patients, officers, or employees, or, in the case of a local association of employees described in section 501(c)(4) organized before May 27, 1969, which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or

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(c) *Advertising, Etc., Activities.*—For purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

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Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.501(c)(6)-1. *Business leagues, chambers of commerce, real estate boards, and boards of trade.*

A business league is an association of persons having some common business interest, the pur-

pose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest, even though all of its income is devoted to the purpose stated. A stock or commodity exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of section 501(c)(6) and is not exempt from tax. Organizations otherwise exempt from tax under this section are taxable under their unrelated business taxable income. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder.

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§ 1.513-1. *Definition of unrelated trade or business.*

(a) *In general.* As used in section 512 the term "unrelated business taxable income" means

the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the modifications provided in section 512. Section 513 specifies with certain exceptions that the phrase "unrelated trade or business" means, in the case of an organization subject to the tax imposed by section 551, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)). (For certain exceptions from this definition, see paragraph (e) of this section. For a special definition of "unrelated trade or business" applicable to certain trusts, see section 513(b)). Therefore, unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

(b) *Trade or business.* The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162—and which, in addition, is not substantially related to the performance of exempt functions—presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross

income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2). Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization. However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

(c) *Regularly carried on*—(1) *General principles.* In determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities

upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

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(d) *Substantially related.*—(1) *In general.* Gross income derives from "unrelated trade or business," within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question—the activiites, that is, of producing or distributing the goods or performing the services involved—and the accomplishment of the organization's exempt purposes.

(2) *Type of relationship required.* Trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the

production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

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(4) *Application of principles*—(i) *Income from performance of exempt functions.* Gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business. The following examples illustrate the application of this principle:

Example (1). M, an organization described in section 501(c)(3), operates a school for training children in the performing arts, such as acting, singing and dancing. It presents performances by its students and derives gross income from admission charges for the performances. The students' participation in performances before audiences is an essential part of their training. Since the income realized from the performances derives from activities which contribute importantly to the accomplishment of M's

exempt purposes, it does not constitute gross income from unrelated trade or business. (For specific exclusion applicable in certain cases of contributed services, see section 513(a)(1) and paragraph (e)(1) of this section.)

Example (2). N is a trade union qualified for exemption under section 501(c)(5). To improve the trade skills of its members, N conducts refresher training courses and supplies handbooks and technical manuals. N receives payments from its members for these services and materials. However, the development and improvement of the skills of its members is one of the purposes for which exemption is granted N; and the activities described contribute importantly to that purpose. Therefore, the income derived from these activities does not constitute gross income from unrelated trade or business.

Example (3). O is an industry trade association qualified for exemption under section 501(c)(6). It presents a trade show in which members of its industry join in an exhibition of industry products. O derives income from charges made to exhibitors for exhibit space and admission fees charged patrons or viewers of the show. The show is not a sales facility for individual exhibitors; its purpose is the promotion and stimulation of interest in, and demand for, the industry's products in general, and it is conducted in a manner reasonably calculated to achieve that purpose. The stimulation of demand for the industry's products in general is one of the purposes for which exemption is granted O. Consequently, the activities produc-

tive of O's gross income from the show—that is, the promotion, organization and conduct of the exhibition—contribute importantly to the achievement of an exempt purpose, and the income does not constitute gross income from unrelated trade or business. See also section 513(d) and regulaitons thereunder regarding sales activity.

(iv) *Exploitation of exempt functions.* In certain cases, activities carried on by an organization in the performance of exempt functions may generate good will or other intangibles which are capable of being exploited in commercial endeavors. Where an organization exploits such an intangible in commercial activities, the mere fact that the resultant income depends in part upon an exempt function of the organization does not make it gross income from related trade or business. In such cases, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is gross income from the conduct of unrelated trade or business. The application of this subdivision is illustrated in the following examples:

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Example (1). U, an exempt scientific organization, enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of various items of laboratory equipment to manufacturers. The endorsing of laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted U. Accordingly, the income derived

from the sale of endorsements is gross income from unrelated trade or business.

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Example (3). W is an exempt business league with a large membership. Under an arrangement with an advertising agency, W regularly mails brochures, pamphlets and other commercial advertising materials to its members, for which service W charges the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of any purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from unrelated trade or business.

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